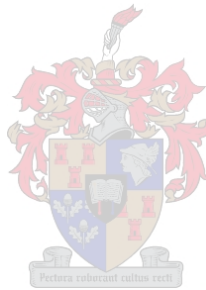


**ASSESSING THE LEVEL OF EFFICIENCY AND EFFECTIVENESS OF
TAX ADMINISTRATION IN ERITREA**

By

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DECLARATION

I, the undersigned, do hereby declare that the work contained in this thesis is my own original work and that I have not previously in its entirety or part submitted it at any university for a degree.

SUMMARY

This paper that is composed of six chapters discusses the basic issues of modern tax administration and the extent to which Eritrean tax administration adheres to the requirements contained in these issues.

The first chapter includes a general introduction, brief historical background of Eritrea, premise, problem definition, objective, design and methods, scope and limitation of the study.

The second chapter deals with the literature review on the theoretical perspective of tax system and administration. There are detailed discussions about the types, characteristics, and functions, ethics of taxes and efficiency and effectiveness of tax administration. This theoretical aspect discusses the basic issues of modern tax administration trends and their development and reforms. The reforms are mainly concerned with prevention of tax evasion, avoidance, corruption and measures taken for making tax administration more efficient and reducing the complexity of taxation laws.

Chapter three explores international success stories in dealing with major tax issues, thereby using the solutions as benchmarks. Experiences in Singapore, Bolivia, Croatia, Jamaica, Guatemala and Spain are used as standards to examine the level of efficiency and effectiveness of tax administration in Eritrea. This chapter also shows that modern tax administrations are concerned with a stronger focus on taxpayers, employees and their development, usage of technology, financial independence and privatisation of those areas that could be better performed by the private sector. To accomplish the above mentioned goals, the above-mentioned countries have set in motion to reform tax administrations with the aim of solving key problems such as low salaries and the connected problems of attracting and retaining high quality personnel and curbing corruption.

The fourth chapter presents the actual situation of tax administration in Eritrea. It deals with missions, objectives, functions, human resource condition, facilities, the level of application of modern technology and the weaknesses and strength of the Inland Revenue Department (IRD). It also describes the measures, which have been taken by IRD administration to motivate its employees and to enhance the voluntary compliance of taxpayers.

The fifth chapter provides a consolidated assessment of the present situation of tax administration in Eritrea based on international experiences of tax administration and on theoretical aspects of taxation. This chapter also scrutinizes the amendments of Proclamation

No. 62/1994 and 64/1994 and their effect on tax administration, saving, consumption and investment in Eritrea.

The sixth chapter provides a conclusion and recommendations that could be used by tax authorities in Eritrea to implement the best practices of tax administration used in the above-mentioned countries.

This study provides an overview on IRD's present situation and how it could successfully manage organisational transformation to achieve significantly increased customer satisfaction, enhanced organisational flexibility, employee motivation and increase in tax collection by following the recommendations based on theory and the experiences of other countries.

OPSOMMING

In hierdie studie wat bestaan uit ses hoofstukke, word die basiese kwessies om moderne belasting administrasie bespreek en die mate waartoe die belasting administrasie van Eritrië daaraan voldoen.

Die eerste hoofstuk sluit die volgende in: 'n algemene inleiding, 'n kort historiese agtergrond oor Eritrië, 'n voorafgaande stelling, 'n probleem definisie, asook die doelwitte, metodes, omvang en delimitasies van die studie.

Die tweede hoofstuk bevat 'n literatuur oorsig oor die teoretiese perspektief op belastingsisteme en administrasie. Daar is gedetailleerde besprekings van die tipes, kenmerke en funksies van belasting asook die etiek daarvan en die doeltreffendheid en effektiwiteit van die belasting administrasie. Hierdie hoofstuk bespreek die basiese kwessies i.v.m. die tendense in belasting administrasie, hoe hulle ontwikkel en hoe hulle hervorm kan word. Die hervormings het meestal betrekking op die voorkoming van belasting ontduiking en vermyding, korrupsie, en metodes om die belasting administrasie meer effektief te maak en om die wette minder ingewikkeld te maak.

Hoofstuk drie gaan in op internasionale suksesverhale i.v.m. belasting en die oplossings word as bakens gebruik. Die effektiwiteit van Eritrië se belastingstelsel word gemeet aan wat gebeur het in ander lande soos Singapore, Boliwië, Kroatie, Jamaika, Guatemala en Spanje. Hierdie hoofstuk toon ook dat moderne belasting administrasie meer fokus op belastingbetalers, werknemers, die gebruik van tegnologie, finansiële onafhanklikheid en die privatisering van areas wat beter deur die privaatsektor bedryf kan word. Om die bostaande te bereik, het die genoemde lande maatreëls ingestel om die belasting administrasie te hervorm en om die volgende sleutelprobleme op te los: lae salarisse, die lok en behou van hoë kwaliteit personeel en die voorkoming van korrupsie.

In die vierde hoofstuk word die eintlike werklikheid van belasting administrasie in Eritrië bespreek. Dit behandel die doelwitte en funksies van die belasting departement (IRD) asook die sterktes en swakhede daarvan en tot hoe 'n mate moderne tegnologie gebruik word. Dit beskryf ook wat die belasting departement gedoen het om sy werknemers te motiveer en om die samewerking van belasting betalers te verseker.

Die vyfde hoofstuk is 'n waardebeoordeling van die eintlike huidige situasie van belasting administrasie in Eritrië gemeet teen internasionale ondervindings en die teoretiese aspekte van belasting. In hierdie hoofstuk word ook gekyk na die amendemente tot Proklamasie No 62/1994

en 64/1994 en hulle uitwerking op belasting administrasie, spaar, verbruik en belegging in Eritrië.

In die sesde hoofstuk is daar gevolgtrekkings en aanbevelings wat die outoriteite in Eritrië kan gebruik. Hulle kan die praktyke wat die beste in ander lande gewerk het, implementeer.

Hierdie studie verskaf 'n oorsig oor die huidige situasie in die Binnelandse Inkomste Departement in Eritrië en oor hoe organisatoriese hervorming kan plaasvind wat sal lei tot beter belasting betalers tevredenheid, meer organisatoriese vlugheid, werknemers motivering en 'n dramatiese vermeerdering in belasting invordering. Hierdie hervorming moet gegrond wees op die aanbevelings soos geformuleer uit die ondervindings van ander lande.

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LIST OF ABBREVIATIONS

CIAT = Centro Interamericano de Administradores Tributarios

CMs = Commissioner' Meetings

DGRI = the General Bureau of Internal Revenue of Bolivia

EDP = Electronic Data Processing

ERN = Eritrean Nakfa

GDP = Gross Domestic Product

GNP = Gross National Product

IDB = Inter-American Development Bank

IMF = International Monetary Fund

IRAS = Inland Revenue Authority of Singapore

IRD = Inland Revenue Department

IRIS = Inland Revenue Integrated System

LDCs = Less Developed Countries

LTO = Large Taxpayer Office

LTU = Large Taxpayer Unit

MDCs = More Developed Countries

MIS = Management Information System

MOF =Ministry of Finance

NGOs = Nongovernmental Organisations

PIN = Personal Identification Number

SRST = Single Stage Retail Sales Tax

VAT = Value Added Tax

WWII =World War II

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CHAPTER ONE

1.1 GENERAL INTRODUCTION

All countries must be able to raise revenues required to finance the services demanded by their citizens and to develop the necessary infrastructure (physical and social) that will enable them to move out of poverty and to prosper. This needs a tax administration, the most important task of which is the efficient application of tax laws which include duties comprising levying, audit, collection, enforcement, identification and assessment (Bejakovic, 2002).

In order to boost revenues, governments broaden the existing tax bases or create new taxes. But the reason for broadening the existing tax base or creating new tax sources differs between more developed countries (MDCs) and less developed countries (LDCs). In LDCs, tax revenues are needed to develop necessary infrastructure for economic development while providing incentive in the private sector for increased investment and output. However, most MDCs need higher tax revenue to finance their rising expenditure on social programmes and plans designed to correct market failure and externalities (Abizadeh & Yousefi, 1996:25).

Although taxes are the main sources of revenue for governments, no one wants to pay taxes, just as no one enjoys paying utility bills. There is a continuous complaint regarding tax systems that are overly complex, unfair, and which inhibits economic growth. However, all people benefit in some way or another from the government's activities those taxes finance. As Chief Justice Oliver Wendell Homes, JR., once noted, "*taxes are what we pay for civilized society*" (Slemrod & Bakija, 1996:1). The teachings of Christianity show that people should pay taxes to the state "Give to Caesar what is Caesar's, and to God what is God's (Matthew 22:21)."

Revenue mobilization in turn requires well-designed tax policies that are translated into clear legislation and that are administratively feasible. A great challenge facing countries is to improve the effectiveness of their tax administrations. The subject of tax administration is extremely important to those concerned with tax policy and its effect on the economy in general. This is true because tax administration plays a crucial role in determining the real or effective tax system, as opposed to the statutory tax system. Indeed, there is a growing conviction among tax policy specialists in developing countries that "*policy change without administration change is nothing*" (Bird & De Jantscher, 1992:iii).

For a given level of government expenditure the alternative to adequate taxation is to run large budget deficits, financed either by borrowing or the printing of money. But this strategy leads to high interest rates and high inflation that hurts private investment, and damages the long-term prospect of economic growth (Tanzi & Zee, 2001:45).

In many countries and specifically in LDCs, public revenue has not kept pace with public expenditure and the ratio of tax revenue to GDP has been small, despite the introduction of new taxes and significant increases in tax rates. Governments recording fiscal deficits on a regular basis have had these deficits accumulate to a significant level of public debt burden, which in turn has led to further demands on public revenue (Tanzi & Schuknecht, 2000:50).

This study entails an assessment of the level of efficiency and effectiveness of tax administration practised by the Inland Revenue Department (IRD) in Eritrea as related to benchmark efforts taken to improve tax administration in Singapore, Bolivia, Croatia, Jamaica, Guatemala and Spain.

1.2. AN OVERVIEW OF SOCIAL, ECONOMIC AND POLITICAL DEVELOPMENT IN ERITREA

Eritrea, one of Africa's youngest states, was founded in 1991, having earlier been in turn an Italian colony (1890-1941), a British protectorate (1942-1952), part of the federal system of Ethiopia (1952-1962) and an Ethiopian province (1962-1991).

Eritrea lies to the north of Ethiopia and forms part of the North East African Region. The area of Eritrea is 124,320 sq km (48,500 sq miles). The more than 3.5 million citizens of Eritrea belong to nine ethnic groups (USAID, 2001).

Looking back at the macroeconomic development and policies during the Italian occupation (1890-1941), considerable investment was made in agriculture and infrastructure with the objective of producing agricultural products for Italy. Numerous food processing and building material enterprises were established in that period, and mineral exploration was started. By the end of the 1930s, over 700 industrial companies, and in excess of 2,000 commercial firms, existed in Eritrea. Eritrea was one of the major exporters to Europe and the Middle East in that period (Danida, 2002).

During the war for liberation (1961-1991), Eritrea's industries and infrastructures stagnated or were destroyed. In 1974 the Mengistu communist regime introduced a planned economy, which entailed nationalization of the most profitable enterprises in the private sector in Eritrea and in Ethiopia as well. Nationalization included everything - not only industries and services such as banks, but even individual premises. In addition, a number of Eritrean industries were dismantled and transferred to Ethiopia. These developments impeded productivity in agriculture and industry. The decline was intensified by the destruction caused by the war, recurrent droughts and famine, the Ethiopian government's neglect of Eritrean industry, and lack of foreign exchange to pay for the import of production equipment.

In a response and to redress the damages, the new government has been committed to a free market economic system and privatisation since 1993. Eritrea's transitional parliament adopted a comprehensive package of legislation in August 1994, setting out the guidelines of future economic policy. The keywords of the new policy were self-sufficiency, the application of technology, encouraging private investment, and procuring foreign capital. To these ends, the government also removed all forms of currency control.

Furthermore, it announced its intention to reduce government holdings in some 40 public enterprises. The process of returning homes to their owners was almost completed by the end of 1995. Some factories had already been sold to private owners and others were in the process of valuation and sale. Across the country, programmes were underway to improve the farming and livestock sectors. Efforts were also being made to develop fishing and tourism as new sources of income. Infrastructure (roads, phones, electricity, etc..) and basic social services such as health and education were being rehabilitated or established from scratch (USAID, 2001).

Eritrea's economy grew at an average of 6% per year from 1994 to 1997, with little or no inflation. During 1998, the procedures for privatisation, business registration, taxation and operation underwent significant revision. All Eritrean legal codes were being harmonized in accordance with the new constitution. These and other changes resulted from Eritrean-led consultative meetings with the World Bank, the International Monetary Fund (IMF) and donors in which these organisations reviewed Eritrea's National Economic Policy Framework Paper. This collaborative effort also started the process of building better partnerships with the donor community (World Bank Group, 2002).

However, a breach in relations between Eritrea and Ethiopia that occurred in May of 1998 caused a border conflict, which erupted into another full-scale war. This conflict was particularly destructive, with opposing massed armies engaging in conventional warfare. The consequence of the war was immense devastation in all sectors of the country. The economic and social damages due to the conflict still loom large. A decade of progress achieved was reversed. The annual growth rate of GDP decreased from 7.9 percent in 1997 to 0.8 percent in 1999 and then to -8.2 percent in 2000. The declining trend in GDP was due to the significant decline in crop production and loss of physical capital. Like the economies of many other African nations, the Eritrean economy is largely based on subsistence agriculture, with 80% of the population involved in farming and herding. Estimates show that the country suffered a decline of about 62 percent in crop production in 2000. Inflation, which was largely under control through mid 1999, increased to 19.9 percent by 2000, and 19.2 percent in 2001. Another consequence of the conflict is the loss of the export market to Ethiopia. Total exports fell from US\$28 million in

1998 to US\$20 million in 1999. It is also estimated that one third of the Eritrea's labour force was in military service and that was another major cause for the fall in food production (World Bank Group, 2002).

In addition, while Eritrea is still struggling to recover from a severe drought and the war of 1998/2000, crops across the region have been devastated by the failure of the first rains and the late arrival of the main rains in 2002. A joint assessment by the United Nations and Eritrean Government has shown that around 1 million people were in urgent need of food assistance in Eritrea (Catholic Agency for Overseas Development, 2002).

However, following the signing of the Peace Accord on 12 December 2000, and the border ruling in April 2002 by an independent commission the situation is normalizing and the full focus of the Eritrean government has shifted towards development and rehabilitation. The government of Eritrea has already started to take various initiatives. The Cabinet of Ministers adopted a comprehensive development project in its session of May 2002. The project known as the "*Warsay-Yikeallo Development Campaign*" aims at reactivating the national economy and promoting accelerated development of the nation. The "*Warsay-Yikealo Campaign*" aims also to reinforce and give additional scope to the rehabilitation endeavours that were already underway in areas of the country before the recent border war. This campaign encompasses the domains of infrastructure, large-scale agriculture both for the domestic market and for export, the development of livestock resources and fisheries, human resources development, a radical approach to education, the establishment and expansion of land, sea, and air transport as well as the launching of housing projects (President Eseyas, 2002).

1.3. MOTIVATION

The challenge for Eritreans in general and for the government of Eritrea in particular is to cope with involving demobilizing and re-integrating almost 300,000 soldiers, re-constructing of war torn infrastructure, re-settling civilians, compensating martyrs' families and rehabilitation and medical treatment of wounded ex-soldiers. Government needs sound financial sources in order to reverse the economic and social slowdown, and to reallocate to social and economic investments.

For these reasons, government has started to make various agreements with donor nations and organisations to get funds in the form of soft loans and/or aid. But these sources present a temporary solution and have in long run, negative implications on the economy of the country. One of the main sources of funding for permanent and continuous development is a sound, fair, simple, productive and well administered tax system.

The main motives for carrying out this study could be summarised as follows:

First, this topic was forwarded by Mr. Berhane Abrehe, the Minister of Finance of Eritrea, to the sponsor of the Eritrean students in South Africa for further research in 2001. This indicates that Eritrea can benefit from tax studies in order to adopt and implement tax policies and to create a sound tax administration at this stage.

Second, the financial report presented in the Cabinet session of May 2002 revealed that the tax revenue has been found to be very low compared to the government expenditure. So, the reason for the lowering of revenue should be discovered by carrying out studies at different divisions of the Ministry of Finance (Minister of Finance, 2002).

Third, as Slemord has pointed out (cited in Bird & De Jantscher, 1992:10) there have been few studies carried out even in developed countries on tax administration. Little has been written about how taxes are administered. The logic behind this is that even a good tax system that is not administered well will not achieve the overall objectives of taxation.

This study will enable the researcher to deepen his own knowledge about taxation and its administration. It will also be a reference to the Department of Inland Revenue (IRD) in Eritrea to take note of the best practices followed by other countries to improve tax administrations.

1.4. PROBLEM DEFINITION

- ❖ It was superficially observed that tax administration in Eritrea needs improvement but how does the tax administration experience of the IRD in Eritrea compare with those inland revenue agencies in other developed and developing countries?
- ❖ Statistics suggest a decline in revenue in relation to GDP in Eritrea since 1997. What are the main causes for this fall in the revenue in relation to GDP in Eritrea in the years after 1997?
- ❖ What steps or measures should be taken to improve the effectiveness and efficiency of tax administration by the IRD?

1.5. PREMISE OF THE STUDY

The ineffectiveness and inefficiency of tax administration in Eritrea are among the causes of the low tax collection and the difficulty in tax collection. The unit of analysis in this study is the IRD in Eritrea. The premise will be tested by contrasting the IRD in Eritrea with the tax collecting agencies of other countries acknowledged to have good practices.

1.6. OBJECTIVES OF THE STUDY

The objective of the study will be the analysis of tax administration practiced by the IRD in Eritrea in relation to the above-mentioned countries.

1.7. SCOPE OF THE STUDY

The study will focus on tax administration by the IRD in Eritrea in the years 1997 and onwards. 1997 was the year in which Eritrea issued its own currency and instituted its own independent monetary policies.

1.8. LIMITATION OF THE STUDY

The literature pertaining to tax administration in Eritrea is limited.

1.9. RESEARCH DESIGN AND METHODOLOGY

This study focuses on the content and general situation of the existing tax administration by the IRD in Eritrea. The study is also comparative in nature. The main sources of data have been both primary and secondary. The sources for secondary data have been books, journals and the Web. The primary data have been derived from the researcher's personal observation and experience, discussion in the form of unstructured interviews with ex-employees of the IRD and through mail communication with the IRD administration and others in Eritrea.

CHAPTER TWO

2. LITERATURE REVIEW ON THEORETICAL ASPECTS OF TAXATION SYSTEMS AND TAX ADMINISTRATION

2.1. INTRODUCTION

In modern societies it is generally accepted that governments have to collect taxes or non-taxes in order to pay for the collective services to be rendered to the public. Like all other demands/wants and needs, the demand for public goods and services is constrained by limited resources on the supply side. So the supply and distribution of public goods and services must be financed through taxation or by other means. The point to be remembered is what the government gives it must first take away (Black, Calitz, Steenekamp & Associates, 1999:113).

This chapter sets the stage for the study of taxation theories, principles, characteristics and functions. It will provide an overview of the different alternatives sources of government revenue; define different taxation terminologies and the purpose of collecting taxes; highlight potential challenges facing improvement of tax administration in developing countries.

Definition of tax

Taxes are the means by which a part of individual's and companies' incomes are diverted into the purchase of public goods. Sommerfield, Andersen & Brock (1979:1.1¹) defined tax as:

Any nonpenal act and compulsory transfer of resources from the private to the public sector, levied on the basis of predetermined criteria and without reference to specific benefits received, in order to accomplish some of a nation's economic and social objectives.

According to the given definition, tax is a compulsory levy made by public authorities for which nothing is received directly in return. Taxes are transfers of resources from person or economic unit to government and are compulsory or legally enforced (Cohen & Cohen cited in Black *et al*, 1999: 114).

A tax can also be distinguished from a criminal or civil penalty in a crude way. A penalty is always devised solely to dissuade a person from engaging in some specific act deemed detrimental to society. For example, a government decides to impose a fine of US\$100 000 on

¹ The first number represents the chapter while the second number is for the page

the wilful failure to file a tax return, the mere possession of illegal weapons or drugs (Sommerfield *et al.*, 1979:1.1).

Taxes generally, do not have such a specific objectives, though they often are intended to influence more general behavioural patterns. The phrase “without reference to a specific benefit received” is used to distinguish between (1) a price that must be paid before anyone may receive private goods or services and (2) the cost of producing public goods and services which are not allocated by price mechanisms. It is difficult to determine a reasonable price and an optimum level of output by the market forces of supply and demand for the public goods and services generally financed from taxes. The national defence force, the legal system, public educational institution, and the network of highways are typically among the services that cannot be parcelled out to a nation’s populace in an acceptable manner by a free market mechanism.

Finally, the phrase “from the private to the public sector” serves only to exclude the possibility of labelling as a tax any intergovernmental transfer of funds. A tax can also be distinguished from an outright confiscation of resources because a tax is levied on the basis of predetermined criteria and on a recurring basis (Sommerfield *et al.*, 1979: 1.3).

2.2. TERMINOLOGIES OF TAXATION

The focus of this section is to define universally accepted key concepts to assist in explaining the theories of taxation, such as the subjects, objectives and basis of taxation as well as the different kinds of tax rates.

Subject of taxation or taxpayer- this is a person or other legal entity that, in terms of the relevant legislation, is personally liable for paying the tax imposed. If the case of South Africa is taken as an example, individuals, companies, close associations, estates of deceased persons, clubs associations, trusts and other legal entities with taxable income are the subjects of taxation (Gildenhuys, 1993:212).

Objects of taxation- the objects of taxation are elements from which the liability to pay tax results. The objects of taxation are therefore *income* in the case of income taxation; *wealth* in the case of taxation on wealth; and *real spending* in the case of consumption taxation. The objects of income tax are *inter alia* personal income of individuals, company income, wages and salaries, and the gross income or turnover of business enterprises. In the case of taxation of wealth, the objects are fixed and personal property, capital transactions and deceased estates. For consumption taxation the objects of taxation may be consumer goods and services, excise goods, imported goods, and negotiable fixed and personal property (Gildenhuys, 1993:212).

Tax base- this is the part of the object of taxation on which the tax payable is calculated. In the case of taxation on income, the bases of taxation are taxable personal income, company profits, the sum of salaries and wages paid by any employer to his /her employees, and the gross turnover of any enterprise. For taxation on wealth, the tax bases are the taxable value of fixed or personal property, capital gain in the case of the capital gains tax, and the value of deceased estates in the case of capital transfer taxes. In the case of consumption taxation the tax bases are the retail prices of consumer goods and services (or the value added to consumer goods and services), the value of excise goods, the landed value of imported goods, and the value of negotiable property (Zodrow &McClure, 1994:168).

Tax rates- this is the percentage of the value of the tax base to be paid by the taxpayer. The tax rate may be proportional, progressive or regressive depending on the particular tax structure that is a function of the ruling of fiscal policy. A proportional rate is a fixed rate uniformly charged to all subjects of taxation irrespective of the value of the tax base, while a progressive rate is one that increases progressively in proportion to the increase in the value of the tax base with the result that a higher percentage tax is paid on a higher value tax base than a lower value tax bases. That is, the marginal rate increases as the tax base increases. The classical progressive tax is income tax. A regressive rate is the one that decreases in proportion to the increase in the value of the tax base, with the result that the higher the value of the tax base the lower the percentage tax paid. In other words, the marginal rate decreases as the value of the tax base increases (Black *et al.*, 1999:116).

General tax- a general tax (broad-based tax) is one which taxes the entire tax base and allows for no exemptions. A value-added tax (VAT) without any exemption or zero-rating is a general tax.

Selective taxes- these are taxes which are imposed on one or a few products or only on income. The whole tax base is therefore not taxed. An excise tax on cigarettes is an example of a selective tax.

Specific and *ad valorem* taxes- taxes can also be specified according to the size or the value of the tax base. The size of the base can be measured in terms of weight, quantities or units. When a fixed amount is imposed per unit of the product the tax is called a *unit tax* or *specific tax*. Examples of specific taxes in South Africa in FY 1999/00 were excise duties on mineral water (12c /litre), and on beer made from malt (R21.22/litre of absolute alcohol). Taxes imposed on the value of products are called *ad valorem* taxes. Such taxes are usually levied as rates (i.e. percentages) of the excisable value (or price) of a commodity. VAT is an example of an *ad valorem* tax (Black *et al.*, 1999:117).

Direct and indirect taxes- taxes can also be distinguished as direct and indirect taxes. Direct taxes are imposed directly on individuals and companies (personal income tax and company tax), while indirect taxes are imposed on commodities (e.g. excise taxes, sales taxes and VAT).

This distinction fundamentally evolves around the issue of tax incidence (i.e. the question of who really pays the tax). From the perspective of tax shifting, direct taxes are taxes that cannot be shifted readily. They are collected from individuals, households or firms and allow for the possibility of adjusting the tax according to the circumstances of the taxpayer (e.g. the marital status, gender, size of the household and poverty level). On the other hand, indirect taxes are able to be shifted and are imposed on commodities or market transactions. It is difficult to adjust the tax rate to personal circumstances of the consumer and it is often possible to shift the burden of tax to someone else. VAT is collected from a merchant who in return can pass on the tax to a consumer who then indirectly bears the burden (Black *et al.*, 1999:118).

Indirect taxation is preferred by tax authorities especially in developing countries because of being relatively simple to administer compared to income tax. Indirect tax is particularly favoured because of its limited scope for tax evasion. Compliance is more easily enforced. Initially, indirect taxes were the most important source of money for government revenue in Europe. Since WWII, however, income taxes and social security contributions have become the most important revenue categories and together account for the greater amounts of government revenue (Tanzi & Schuknecht, 2000:55).

2.3. SOURCES OF GOVERNMENT FUNDS

Taxes as the main source of government revenue, accounted on average for about 80% of the total revenue in all countries in 1999 (Jones & Basu, 2002:35-50). In 1998/99 taxes constituted approximately 89.7% of the total revenue in South Africa (Black *et al.*, 1999:113). Taxation thus makes up a major source of government revenue in most countries.

It is essential that a tax system especially in the developing countries should raise adequate revenue to prevent excessive government borrowing and should do so without discouraging economic activity and without deviating too much from the tax systems of other countries.

Taxes, however, are not the only instruments available to the government for raising revenue or engaging in redistribution, regulation, stabilization or the promotion of merit wants. Nor are taxes always the best instruments in different situations. In fact in some cases non-tax instruments can substitute for taxes. There are several instances in orthodox public economic theory where they are also shown to be useful complements to taxation. So it is necessary to examine the nature and role of the alternative and complementary instruments that are available

to governments. The major alternatives include fees and charges, government debt, printing paper money (not preferable), inflation tax and subsidies, transfers and fiscal monopolies besides direct regulatory instruments (Black *et al.*, 1999:113). Although these sources of funds are not administered under IRD in Eritrea, it will be worthwhile to elaborate on the nature of some of them as alternatives for consideration.

User charges or benefit taxes are prices charged for the delivery of certain public goods and services. User charges are amounts of money paid for the use of public goods containing both collective and quasi-collective services. User charges serve to provide tax relief to the taxpayer by meeting the operational cost of the public service. In addition, user charges have efficiency benefits and create a level of equity in the process of financing some of the public services. The collective capital goods part is generally financed by taxation while day-to-day operations are financed through user charges. These charges are set politically and they can only be levied if exclusions are possible. Examples in the case of South Africa include toll roads, public swimming pools, ambulances and university education (Gildenhuys, 1993: 361).

Consumer tariffs-differ from user charges to the extent that consumer tariffs are paid for public goods and services which are completely exhaustible and must be replenished as consumption continues. They are exclusive which means those consumers who do not pay for them can be excluded from their consumption. The objects of consumer tariffs can only be particular consumer goods and services that may include fresh produce marketing, abattoirs, water services and public transport (Gildenhuys, 1993: 366).

Administrative fees are similar to user charges but differ in the sense that the service (or benefit) in return for the fee is defined rather broadly and imprecisely. Such fees include business licences, television licenses, and diamond export rights, fishing licenses, and motor vehicle licenses, as well as parking and speeding fines.

Borrowing- a government can borrow from its citizens or from abroad to finance capital expenditures. However, it is imperative that the borrowed money should be spent on productive activities. Unfortunately governments sometimes use borrowed funds to finance current consumption and this increases the debts particularly of developing countries without commensurate developmental asset benefit.

Government induced inflation-inflation changes the real value of public debt. If the government borrows US\$ 2000 from a taxpayer and the inflation rate is 10 percent, then in a year's time the real value of the loan is US\$1800 ($R2000 - [10/100 \times 2000]$). If the value of the loan is not linked to a price index the real value of the government debt decreases. So in this

case it may also be said that the government finances its expenditures with an inflation tax (Black *et al.*, 1999:114).

2.4. FUNCTIONS OF TAXATION

Taxes in addition to other methods of generating income are potential instruments for promoting economic and social objectives in all countries. According to Gildenhuys (1993:214), taxation serves three primary functions, namely: (1) generating enough revenue to finance the costs of collective goods and services ;(2) redistributing income and wealth: and (3) when overall demand in the economy is excessive, reducing private income and consequently private spending.

2.4.1. Revenue function

The conventional view on taxation is that it serves mainly to cover the costs of collective services. In other words taxes are to government what incomes are to business and to individuals. As the source of the state income, tax is an integral major tool of the modern society (Bubenchikov, 2002:4).

The revenue function raises questions about the relative values of public versus private goods and services amongst taxpayers. The most important problem for any government is that it cannot rely on market indicators to determine the relative choice of taxpayers between public and private goods and services. The government receives indicators on this through the working of the political process by which individuals and groups express their demands and choices. Thus, political decision-making becomes a substitute for preference expression by the market. The result will not please every one, and, the political decision -making is less perfect than the market mechanism for determining relative preferences (Gildenhuys, 1993:216).

Another aspect of the tax revenue function to be considered is whether a tax charged on a specific tax base will generate adequate revenue to comply with the needs of the public sector. The necessity for revenue adequacy and certainty demands a stable tax base able to supply adequate revenue in spite of economic fluctuations. The provision of resources for the supply of public goods and services is the main justification for taxation. Taxation is therefore supposed to be imposed in the least painful way and is to be kept at the right levels necessary to present resources needed to provide the desired public goods. Taxes levied for revenue are worthwhile only if they can generate meaningful revenue at socially acceptable rates. Taxes generally should not be high in order not to encourage tax evasion or discourage economic activities. If this so it becomes a matter of killing the goose that lays golden egg (Lebaube & Vehorn, 1992:310; Tanzi, 1991:9).

2.4.2. Redistribution of wealth function

Many of the objectives associated with tax policies are as much social as they are economic. Wealth distribution, for example, may be sought either because of social value judgements that call for the distribution of private wealth to bring about social equality or because of an economic judgement that wealth redistribution is required to maintain a desired level of economic health. The latter argument typically proceeds on the assumption that large concentrations of wealth and income tend to reduce aggregate demand below a satisfactory level since high-income earners spend a smaller portion of their incomes than do persons with lower incomes. Therefore, the progressive tax rate structure associated with personal income rates in most countries can be rationalized satisfactorily on the basis that progressive income taxation contributes to a more equal distribution of a nation's wealth (Sommerfield *et al.*, 1979:1.9).

When more tax is collected from one taxpayer than from another, and both receive the same value of collective services equal to the per capita cost for rendering such services, then redistribution of wealth takes place. The aim of redistribution is to leave less money in the pocket of the wealthier taxpayers and more in the pocket of the less wealthier taxpayers after tax. Since the productive ability of individuals varies greatly, there will always be wealth differentials in any community resulting from individual enterprise. The objective of the redistribution function of taxation is to minimise this natural differentiation in wealth (Gildenhuys, 1993:218).

According to Musgrave (1986:258-260), the fiscal instruments for redistribution are:

- ❖ A tax-transfer scheme, combining progressive taxation of high-income households with a subsidy to low-income households;
- ❖ A progressive income tax used to finance public services, especially those such as public housing, which particularly benefit low-income households; and
- ❖ A combination of taxes on goods purchased largely by high-income consumers with subsidies of other goods, which are used chiefly by low-income consumers.

But the fiscal policy benefits do not always reach their target groups in full. The benefits of wealth re-distribution policy are often largely absorbed by high administrative costs leaving just a small portion eventually to reach the policy target group.

2.4.3. Economic regulation function

The classical view is that taxation can also be used to create economic stability and impact on circumstances for economic growth. Changes in the tax structure are applied so that

unemployment and inflation are limited to the minimum in order to enhance economic growth (Gildenhuys, 1993:220).

One of the fundamental reasons why a government taxes its citizens is to provide a reasonable degree of price stability within that given nation. If any government purchases substantial amount of goods and services without taxing, aggregate spending by the public and private sectors will quickly generate a strong excess demand and cause an inflationary bias in the economy. In order to maintain price stability, governments must either decrease their own spending or decrease private spending. Then when public spending is decided politically, tax policies are set to become the residual buffer that regulate private and public demands with output (Musgrave, 1986:152).

The economic function of taxes within a national economy as a whole is also shown at the stages of the business cycle in the so-called automatic fiscal policy expressed in “automatic” change of tax receipts and state expenditures as a result of the change of the volume of production and incomes. Economic stabilization measures involve governments making direct interventions in their national economies through taxation. During a recession the revenues from the enterprises and private persons are reduced, and also tax payments, therefore, are automatically reduced. Furthermore, during a recession the state is often compelled to increase social welfare allowances to the population. This gain in incomes operates also as stabilizers or automatic regulators compensating for the fluctuations of the incomes and, accordingly, the fluctuation of individual costs (Bubenchikov, 2002:4).

In addition to price stability, governments should also work to promote the near full-employment of all resources and ensure a satisfactory rate of economic growth. For example, reducing personal and corporate income tax rate increases aggregate demand to maintain a desired level of economic activities and at the same time raises the total tax revenue. In most developing nations as a group, a common problem is that the portion of the nation’s income devoted for investment is too small, while the portion for consumption is too large. The tendency to consume nearly all the Gross National Product (GNP) is inevitable when a large and growing population is located in an economically poor country. Yet some saving and investment is essential if a country is to break out of the poverty cycle. Carefully selected forms of taxation can help to rectify these shortcomings by reducing private consumption (Sommerfield *et al.*, 1979:1.7).

Taxes affect the terms of almost every economic decision. In the US in 1994, federal taxes consumed 20.5% of the gross domestic product, while the state and local taxes took up another 11.1%. This shows that taxes have a great impact on the size of the rewards people can get from

saving, working hard, taking a second job and investing in education or training. Taxes also affect how much it costs to contribute to charity, buy a house or put children in day care, how much to invest in new technology or where to locate a factory in any part of the world (Slemrod & Bakija, 1996:4).

2.5. TYPES OF TAXES

There are three main types of taxes, namely taxes on income, wealth and consumption. Income and consumption taxes are levied on the flow of value whereas the wealth taxes are tax on accumulations rather than transfers. Wealth taxes are not administered by IRD in Eritrea, therefore, there will be no further elaboration on them.

2.5.1. Income taxation

Income tax measures the value flow received by a taxpayer, and subtracts such outgoing expenses flows matched to those receipts. A properly designed income tax would provide a desirable tax structure from the point of view of both the allocation and the distribution functions of the government in a development context. Further, due to the income distribution concern as seen by most developing countries, it is desirable to have a tax system that is progressive, in the sense that those at higher levels of income would pay higher proportions of their incomes in tax (Lewis JR, 1984:52).

But in order to operate an income tax, it is essential to define precisely what is meant by income. This may at first glance seem straight forward. However, in many situations defining income is problematic. According to Zodrwa & McLure (1994:169), Robert M. Haig defined income “*as the money value of the net accretion to one’s economic power between two points of time* “. Henry C. Simon has defined personal income as the algebraic sum of “(1) *the market value of rights exercised in consumption and (2) the change in the value of the property rights between the beginning and the end of the period in question.*”. Slemrod & Bakija (1996:32) in turn argued that an income is a measure of money and other gains received in a given period of time, from all sources, which can be used, either now or later, to purchase goods & services.

Income can be defined from both the sources side and the uses side of the budget. From the uses side, income is the monetary value of the consumption plus any change in the net worth over a year. While from the sources side of the budget, anything that makes consumption possible (i.e. anything that is available to finance consumption) is considered as income (Black *et al.*, 1999: 154).

The transactions which produce income for tax purpose for example are: wages, salaries, interest on investments, stock dividends, royalties, income from professional services, from business

activities from farming. For administrative and other reasons governments tend to tax income sources separately. In South Africa and most other countries, for example, income can be classified into the following categories: personal income, corporate income, payroll tax and turnover tax (Gildenhuys, 1993:247; Black *et al.*, 1999: 154).

The common goals of income taxation can be considered from three perspectives. First from an administrative point of view, the purpose of income tax is to supply enough revenue for financing public services and goods. This goal tempts governments into imposing a progressive income tax system, in spite of its inequity, because it is the most productive one. Second from a political point of view, the purpose of income tax is the redistribution of wealth, which aims at the elimination of unequal distribution of per capita income. While the third perspective is economic regulation based on its premise that income tax is suitable instrument for creating economic stability because disposable income in the pockets of taxpayers increases in the case of tax decrease while disposable income decreases in the case of a tax increase (Gildenhuys, 1993:254-255).

For the sake of this study, there will be some elaborations on personal, payroll and corporate (business) taxes. The first two are parts of the Eritrean taxation system and although payroll taxes have not yet been introduced in Eritrea, they merit consideration in the quest of tax reform.

2.5.1.1. Personal taxation

Gross income is technically made up of receipts and accruals (e.g. wages, salaries, dividends, rents and royalties and interests). This gross income has to be reconciled through an accounting process before being taxed. Income taxation is characterised by a tendency to allow for exclusions, exemptions, deductions and rebates in order to promote equity. This, however, shrinks the tax base and complicates administration. Exclusions are affected when some form of non-cash income such as payments in kinds are excluded from the tax base. Exemption is a type of tax expenditure that is common in administration whereby certain persons or groups of people are declared exempted from paying income tax such as, soldiers and religious officials. It is also done by the government as a method of providing tax relief to the poor and aged. Deductions in turn occur when certain types of expenditure are excluded from tax liability as a part of personal income tax base, e.g., medical expenses. Tax rebates involve the subtraction of a specified amount from the tax to be paid. Therefore, calculating personal income tax is a process which starts from gross income to net taxable income (Black *et al.*, 1999: 159).

2.5.1.2. Corporate taxation

Companies are owned by individuals but governments tax them separately from personal incomes. Some of the reasons which are advanced to justify this practice are (Black *et al.*, 1999:168; Sommerfield *et al.*, 1979:1.9):

- ❖ From a legal point of view companies are taxed as separate entities, recognized by the law as a legal personality. They function as independent institutions with their own identities. This separate legal existence gives the corporate form its legal advantage of limited liability, transferability of shares and continuity of existence;
- ❖ Companies receive benefits from the government, which include security and protection and business environment. They utilise these services in their own right. These public services are financed through taxation. So companies' incomes become liable for taxation;
- ❖ Companies are taxed separately from shareholders in order to control the possibility of tax avoidance. If companies were not taxed shareholders would decide to retain their personal incomes in the companies, thus limiting their liability to personal income taxation.
- ❖ Company taxation is administratively simple, which is advantageous, especially in countries that have limited capacity in the administration of income tax; and
- ❖ The choice is also politically expedient because corporate taxes can constantly produce large amounts of revenue.

2.5.1.3. Payroll income

Payroll tax is yet another tax with income as its base. It has many forms. In the USA, for example, the social insurance benefits *inter alia* include old-aged insurance, disability insurance, hospital insurance and unemployment insurance. While in South Africa, typical forms of payroll taxation are unemployment, workman's compensation and the service levy of certain local governments. The functions of these payroll taxes differ according to their purposes. As a social insurance the purpose is to serve as type of compulsory insurance to protect financially both employees and employers. For instance, workman's compensation insurance guarantees employees compensation for medical costs as well as for loss of income caused by temporary unfitness in the course of their employment. The rationale behind this kind of levy is apparently the distribution of wealth from the wealthier and from developed urban areas to the underdeveloped and less wealthier rural areas (Gildenhuys, 1993:275).

2.5.2. Consumption taxation

Consumption taxes are intended to be borne by consumers and are dependent upon retailers acting as tax collectors. Sellers bear the cost of determining the applicable tax rate, preparing invoices according to tax rules; collecting tax; filing and remitting tax; and maintaining tax records. If the tax is assessed incorrectly, the seller (or its third-party agent) typically will be held responsible for any shortfall and will not be able to reclaim it from the customer (Jones & Basu, 2002:35-52).

Unlike wealth and income taxation, consumption taxation is an indirect form of taxation because (i) it does not take the personal circumstances of the taxpayers into account ;(ii) it is collected by a third person on behalf of the government; and (iii) in most cases it is invisible to the taxpayer at the stage of payment. The different kinds of consumer taxes generally imposed are general (retail) sales taxes, value added tax (VAT), excise duty, import duty and surcharge on imports. These consumption taxes yield significant revenue to governments under normal conditions. Consumption taxation is subject to two paramount requirements, those of uniformity and neutrality. The objects of consumption are consumer goods and services purchased by the consumers (Gildenhuis, 1993:334; Black *et al.*, 1999:118).

The objectives of consumption tax may be one or more of the following: supply additional revenue; to discourage the consumption of certain commodities which are harmful to the health of the consumer, by taxing them heavily; to protect domestic production against foreign competition; or to maintain a positive balance of payment in a country's foreign exchange relations (Gildenhuis, 1993:335).

In addition, consumption taxes can be used to achieve multiple objectives (Black *et al.*, 1999: 196). They can be used as deterrents and protection measures. For example consumption taxes are used for environment protection whereby those commodities which have environmental impact, are being highly taxed to discourage their application. The same applies to health issues. It is common today that taxes on tobacco and its products and alcoholic beverages are very high in many countries as a way of discouraging their utilization. It will be valuable having a look at sales tax and VAT with more elaboration for the sake of this study.

2.5.2.1. Sales taxes

General sales tax is a single-stage retail tax. It is usually imposed on any transaction where tangible movable goods are sold or imported for final use or consumption. Goods for resale at the retail level or for the purpose of conversion into final consumer products are not taxed. This tax is also levied on transactions such as leasehold transactions, the lease of tangible movable

goods, all kinds of professional services, board and lodging supplied by hotel industry, the lease of camping and caravan sites and goods purchased, or manufactured goods retained by the owner of a business for personal use.

According to Gildenhuys (1993:336), an ideal sales tax has the following characteristics:

- ❖ It is imposed on transactions rather than on commodities;
- ❖ It is neutral; and
- ❖ It avoids double taxation.

According to Daniels (2000), sales taxes which fall upon consumption, are favoured by some theorists because they do not depress savings or unduly burden capital (as income taxes are believed to do.). They are fairly easy to collect, because only business entities need to be monitored. They may also have the advantage of being "voluntary", in the sense that one can avoid the tax by not purchasing the item.

Gildenhuys (1993:336) also summarised the important advantages of sales taxes as follows:

- ❖ The broad base of sales tax makes it possible to collect much revenue at relatively low tax rates. Therefore, as far as the revenue function is concerned, a sales tax is relatively productive.
- ❖ The elasticity and sensitivity of a sales tax lead to a fast and regular revenue flow for the government. The almost immediate reaction to a change in either the tax rate or the base makes it an effective fiscal policy instrument.
- ❖ The cost of the collection and administration of sales tax as percentage of total yield is low.
- ❖ Regular involvement with the tax should result in a far better understanding of the laws and practices by responsible staff members than would be the case with, for example, income tax.
- ❖ The tax amount on individual transactions is relatively small and this may eliminate any opposition against sales taxes. Individual payments are painless, so there is less pressure to avoid or evade sales taxes.

But sales taxes have some disadvantages. For instance, if sales taxes are charged on business inputs in addition to household consumption, they create major economic distortions, because the tax is effectively being charged twice (once on business inputs, a second time on the consumed outputs.). The remedies, which are introduced, must avoid this complexity. They can take the form of exemption certificates, or the form of rules allowing sellers to deduct the cost of

inputs or get credit for taxes paid on inputs. Sales taxes usually have a direct effect on prices and can serve as the beginning of a price-wage spiral. It is also difficult to apply sales taxes to intangibles, or to services, particularly those involving financial intermediaries. Again consumers have no incentive to make sure whether retailers are paying their sales taxes, and retailers have no incentive to pay aside from the threat of audit. Finally, such taxes are intrinsically non-progressive and discriminate against the lower-income households (Daniels, 2000).

For countries with sophisticated tax administration and good taxpayer compliance, single-stage retail sales tax is an attractive option. However, problems begin to accumulate as the tax rate rises because it becomes extremely tempting to evade and/or avoid taxes. Only Iceland, Norway, South Africa, Sweden and Zimbabwe had operated retail taxes at rates over 10 percent. But most of them have decided to switch to VAT later (Tait, 1988:17-18).

2.5.2.2. Value added tax (VAT)

This tax is levied on value added at different stages of production or trading process. It is levied on a net basis, which is only the value added in each successive stage is taxed. Roughly speaking, VAT is the difference between sales and purchases of intermediate goods and services over a certain period of time. For instance, if a retailer purchases goods to the value of R 150,000 from suppliers in a month and has sales worth R 300,000 in that month, the value added by the retailer would be R (300,000-150,000) 150,000 on which the tax will be applied. VAT is intended to be a broad-based indirect tax charged on consumption goods and services. It is charged by the vendor on his/her customers (output tax) and paid by the vendor to his/her suppliers (input tax). The difference between the output tax charged and the input tax paid by the vendor will either be paid to or refunded by the revenue collecting authority (Black *et al.*, 1999:19; Dreinstock, Friendland, Levenstien & partners, 1991:1).

By contrast with retail sales tax, which is a single-stage sales tax and levied only at the end where goods are sold to the final consumer, VAT is levied on each transaction in the trading process, from the primary procedures and importers and the intermediate manufacturers and traders and final consumers. To avoid accumulation of taxation (double taxation) at a given tax rate, the input tax of the vendor is credited to the vendor's account and the output tax is debited. The difference between the input tax and the output represents the tax on the value the vendor added to the product. The value added has two components, namely the cost of production and processing plus profit (Gildenhuys, 1993:345-346; Tait, 1988:4).

The following table compares the working of VAT with a single-stage retail sales tax (SRST) to show that, at the same fixed proportional rate of 10 percent, both yield the same revenue.

Table 1: Comparison of yields between VAT and (SRST) at 10 percent.

| Stages | | VAT | SRST |
|-----------------------|--------------|------|--------------|
| Enterprise A: | | | |
| Purchases | R200 | | R200 |
| Plus: Processing cost | 40 | | 40 |
| Profit | <u>20</u> | | <u>20</u> |
| Sales price | 250 | | 250 |
| Tax (250*10%)= | <u>25</u> | R25 | Nil |
| | R275 | | R250 |
| Enterprise B: | | | |
| Purchases | R275 | | R250 |
| Minus :tax credit | <u>25</u> | | <u>Nil</u> |
| | R 250 | | R 250 |
| Plus: Processing cost | 15 | | 15 |
| Profit | <u>5</u> | | <u>5</u> |
| Sale price | R 270 | | <u>R 270</u> |
| Tax (270*10%) | <u>27</u> | R2 | <u>27</u> |
| Final consumer price | <u>R 297</u> | | <u>R 297</u> |
| Total VAT and SRST | | R 27 | R 27 |

This table shows that the two tax systems yield the same amount of revenue at the same rate. The question is then, why is VAT to be preferred to SRST if both yield the same revenue? According to Aaron (1981: 2-3), there are two circumstances in which VAT can be appropriate. *Firstly*, VAT is appropriate if tax evasion and lack of vendor co-operation is a problem. VAT induces every purchaser to demand a documented receipt from every vendor for taxes paid. So, the vendor will be forced to pay the tax to the government because the person purchasing the goods from him/her will demand a tax receipts for credit purpose, and so on through the whole exchange channel to the final consumer. *Secondly*, governments sometimes choose to remove domestic taxes from items that will be sold in international trade. The chain of tax

documentation produced by VAT makes the zero-rating of exports easy, because the exporters do not collect tax from their foreign clients.

Some of the advantages and disadvantages of VAT in comparison with a SRST are condensed as follows (Gildenhuys, 1993:350-351; Slemrod & Bakija, 1996:209-211):

- ❖ VAT is claimed to make tax administration much easier and considerably simpler to enforce;
- ❖ The elasticity of VAT is appropriately the same as that of a SRST;
- ❖ The collection of a SRST is much easier because the full amount of tax is collected at only one stage and almost no refund is made;
- ❖ As far as regressivity and its impact on consumer prices are concerned, VAT has advantage over SRST. Because the VAT is spread over a range of transactions and its impact at each stage represents only a fraction of the total tax eventually collected;
- ❖ Under SRST all the revenue is at risk if the retailer successfully claims all his/her credit on purchase. But this is more difficult to do under the accounting requirement of VAT;
- ❖ Some purchasers in the case of VAT may be large enterprises with great purchasing power who are thus in a strong bargaining position to negotiate the best prices with their suppliers and this results in lower consumer prices for the final consumer; and
- ❖ Tax evasion is not as easy in the case of VAT as it is in the case of SRST. Firstly, VAT has a clearer audit trail. Secondly, an even greater proportion of the tax is collected from large business, which is subject to more efficient record keeping as well as to an external audit. Thirdly, the amount of the tax collected at each point is only a fraction of the total and thus the incentive to evade is greatly reduced.

2.6. THE PROPERTIES OF A GOOD TAXATION SYSTEM

Tax systems evolve as new taxes are introduced and others are amended from time to time. The question is whether such changes are good or bad. To evaluate the changes a list of criteria are used. The most important ones are equity, economic efficiency, administrative efficiency and flexibility (Black *et al.*, 1999:118).

It is also possible to decide whether to impose a tax and to judge its equity, efficiency, effectiveness and long-term acceptability if the following criteria are in place. The criteria are (Gildenhuys, 1993:233-239)

Fairness- A tax should reflect the ability to pay of those who bear its burden, or the tax burden should be matched by the benefit that taxpayers receive.

Certainty- The rules of taxation should be simple, clearly stated and evenly applied. Certainty in this regard means that the taxpayer should be reasonably certain of what his/her tax liability would be in any given set of circumstances.

Convenience- A tax should be convenient to pay, with billing dates that coincide with the income flow of taxpayers.

Efficiency and effectiveness- Fair tax administration should be feasible and efficient. The collection and compliance costs should not be out of proportion to any given revenue.

Tax visibility- Taxes should be visible so that each taxpayer knows what he/she is paying and calls the government to account for the revenue spent. This is one the most crucial canons of democratic financial administration.

Productivity- A tax should produce sufficient and stable revenue. Tax productivity is influenced by tax elasticity. Elastic tax reacts proportionally more to changes in the tax base and generates proportionately larger amounts of revenue.

Neutrality- The principle of tax neutrality requires that people should not be influenced by the tax system in choosing one course of economic action rather than another solely or predominantly because their tax position would be better under one of the options. In other words a tax should not distort the way a community would otherwise use its resources.

According to Bubenichikov (2002:7-8), the basic principles of tax system construction were formulated by A. Smith and they were: uniformity, distinctness, simplicity and cheapness. But these principles can be put in different ways to suit different environments. For instance, the Tax Code of the Russian Federation includes the following principles:

- ❖ *Universality* -every person must pay legally established taxes and levies;
- ❖ *Equality*- it shall not be permissible to establish differentiated rates of taxes and levies or tax exemptions depending on form of ownership, the nationality of physical persons or the place of origin of capital;
- ❖ *Fairness*- in establishing taxes authorities should consider the actual ability of the taxpayer to pay the tax;
- ❖ *Indiscriminate nature*- taxes and levies may not be applied differently on the basis of social, racial, national, religious or other similar criteria;

- ❖ *Obligatory economic basis* -taxes and levies must have an economic basis and may not be arbitrary; and
- ❖ *Constitutionality*- it shall not be permissible to establish taxes and levies which violate the single economic space of the Russian Federation, hinder citizens from exercising their constitutional rights, or otherwise restrict or create hindrances to the economic activities of physical persons and organisations which are not prohibited by law.

In addition, taxes should promote an equitable (fair) distribution of income. Equity is a major objective of taxation. Equity denotes the spirit and the habit of fairness and justice and right dealing which would regulate the intercourse of person to person- the rule of doing to others, as “we desire to do to us”. It is generally agreed that the entire tax system should be equitable, that is, each taxpayer should contribute his or her “fair share” to the cost of government. One of the most important judgements in tax analysis is whether or not the distribution impact of tax is equitable or fair. Fairness, however, is a subjective concept and like beauty it lies in the eyes of the beholder (Gildenhuys, 1993:225).

According to Black *et al.* (1999:119), in his first maxim of taxation Adam Smith (1776) stated that: “*The subjects of every state ought to contribute towards the support of the government as nearly as possible, in proportion to their respective abilities; that is in proportion to the revenue which they respectively enjoy under the protection of the state.*” The equity principle does not allow sacrifices, forced upon an individual or group to be justified by inherent benefits for the majority. To this end, salient aspects of the theory of taxation are reviewed in the form of principles of “benefit-received” and “ability-to-pay”. These principles form the conceptual canons for studying taxation as discussed below.

2.6.1. Benefit-received principle

This principle stipulates that the tax burden of government expenditure should be apportioned to the taxpayers in accordance with the benefits each receives under the protection of the state. This approach to equity invokes the benefit principle, which states that an equitable tax system is one in which each taxpayer pays in line with the benefits received from a public service. Everyone should get what he/she pays for and everyone should pay for what he/she gets. It is analogous to the way in which market charges the consumers when buying private goods and services; they should pay in the line with marginal evaluation. Its application is a matter of *quid pro quo* and has no redistribution function (Black *et al.*, 1999:119).

Non-users of particular governmental services are not required to pay. Examples of benefit taxes are admission, tolls for roads and bridges, gasoline taxes, airport fees, and license and permit

fees. Benefit taxation allows taxpayers to know clearly how their money is being spent because it connects a tax with its outcome. The application of benefit taxes is considered desirable under conditions in which the nature of the service is private and consumption clearly benefits the payer to the exclusion of others. Individual purchasers of services may even apply a market test (such as a comparison of costs and benefits) before a decision to buy is made (Musgrave, 2000:204).

But the benefit principle is not applicable to all services because some are not fully private. Instead, some services are social and thus benefit others as well as the purchaser. National defence, policing and clean air are probably the model examples of fully public services; if enjoyed by one, all enjoys them. Obviously, these do not permit the application of the benefit principle. However, there are mixed services that have elements of both personal and social benefits. Mixed services occupy a large category of public services, including education, health, and social welfare (Black *et al.*, 1999:120).

2.6.2 Ability-to-pay principle

This approach to equity calls to mind the ability-to-pay principle, which states that people should contribute to the costs of government in line with their financial resources. In this approach tax equity is seen not in relation to expenditure benefits, but as matter of fairness in the distribution of the tax burden only. A person's contribution to tax the bill should be in line with his/her ability to pay. Taxable units with equal ability should contribute the same in order to fulfil the requirement of "*horizontal equity*". While those with high ability should pay more to satisfy the principle of "*vertical equity*" (James & Nobes, 1978:75).

Under this approach, the total tax burden is established through normal political processes such as elections or referenda, and then each taxpayer is required to contribute according to his or her tax-paying capacity. Because taxes are paid mostly from income, each tax may be assessed for its consistency with the ability-to-pay principle by relating it to the income of the individual taxpayer. If low-income people pay a greater percentage of their income toward the tax than high-income taxpayers, the tax is labelled "regressive." If the reverse is true, the tax is called "progressive". Therefore, in accordance with people's ability-to-pay income taxes achieve this aim reasonably well while sales taxes fail rather badly. A difficulty arises as to how progressive a taxation system ought to be. Ideally, households should support governmental services by making equal sacrifices (Musgrave, 2000:182).

However, the ability-to-pay principle is sometimes violated in delivering some public services. This can happen for example, with reference to school fees when students of different socio-economic levels pay the same rate for a service, such as participation in athletics.

2.7. GENERAL TRENDS OF MODERN TAX ADMINISTRATION

The general trends in reforms of tax administration are towards independence and professionalisation. As has already been mentioned earlier, tax administration is usually a part of public administration and administered under the ministry of finance in most countries. Due to budget restrictions, those employed in public administration regularly earn less than those in the private sector. Low salaries can neither attract nor keep high quality personnel in any country. However, the public sector in general and the tax administration in particular offer opportunities for gaining expertise that may be useful in the private sector (World Bank, 2002).

This results in a rather widespread opinion among the public that tax administration is inefficient, incapable and corruptive in most developing countries. Once such opinion has taken roots, the tendency is to cut salaries even more, which leaves those employed even further behind the salaries received by the private sector. Governments are often fully aware of these circumstances and respond by turning a blind eye to a system of unofficial payments that allows tax administration to survive. This further decreases public revenue and increases costs for taxpayers who have to bear the additional burden of these non-formal outlays. This results in a highly dangerous situation in which the public comes to doubt the integrity and efficacy of the personnel, which directly influences their readiness to willingly pay taxes. The government's primary task should therefore be to reverse the process and make tax administration a professional organisation offering good salaries and attracting people of great talent (Ott, 1998).

Thus, the administrative bodies of tax administration should be similar to those of private financial institutions such as central banks, which are usually more competent than tax administrations. There must be incentives to attract young people who prefer working for the private sector institutions because the salaries are higher, the possibilities of advancement are better, there is opportunity to exercise individual ability and judgment, the facilities are superior and more sophisticated and work conditions are better. This is especially common in less developed countries. All these are reasons for the establishment of tax administration agencies that are independent of ministries of finance. This would also encourage professionalism or, more precisely (1) the rewarding and promotion of employees according to the responsibility of their job and their success in performing it; (2) a job classification system which clearly defines the responsibilities of each position; (3) independence from political influence and pressure enabling people to retain their jobs long enough to pay back their education; (4) setting up minimal conditions for each position and objective testing and (5) continuous education modified according and adjusted to the needs of each individual job position (Schlemenson, 1992:358).

The functions of tax administration, the influence of tax laws complexity of tax administration, basic elements and the main tasks of tax administration reform are discussed in the following sections.

2.7.1. Functions of tax administration

According to Bird & De Jantscher (1992:9-10), tax administration has three functions. The first is to facilitate tax compliance by providing clear instructions, simple tax forms and information to taxpayers. The second function is monitoring compliance by establishing and maintaining taxpayers accounts through proper information system management covering both ultimate taxpayers and third party agents such as banks, involved in the tax system, as well as appropriate and prompt procedures to detect and follow up nonfilers and delayed payment. The third function of tax administration deals with non-compliance where strict measures are needed to be taken against those who try to avoid or evade tax. Deterring non-compliance requires both establishing reasonable risk detection and applying penalties effectively.

According to the World Bank (2002), the main tasks of tax administration are as follows:

- ❖ Providing information and instruction to taxpayers;
- ❖ Registering, organising and processing tax returns (input of data, processing declarations and payments);
- ❖ Coercive collection (closely connected with registration, accounting and return processing);
- ❖ Control and supervision (discovering lacking and inadequate tax returns and controls of books and papers in tax administration offices or business activities and books of taxpayers, making routine check-ups by accounting and return processing department); and
- ❖ Legal services and complaints (taking cases to court, defending tax administration in court, explaining procedures in accordance with the law).

Moreover, tax administration should be considered on the one hand as a production unit that has to collect taxes and on the other hand as a service unit established to provide a sound relation between taxpayers and tax administration. The link should foster cooperative efforts between taxpayers and tax administration in serving fiscal requirement. The efficiency of the link has to be measured by the progress in mitigating tax compliance and designing a tax policy that enhances the development process and equity (Robinson, 2002:5).

An inclination towards functional organisation of tax administration prevails in modern theory and practice. This means introducing more specialised activities that give far better support to self-assessment of the taxation system. Tax administration should develop around activities (such as calculation or supervision and control) and not according to the type of taxes or taxpayers. This enhances tracking non-compliant taxpayers.

According to Erven (2002), the advantages of organizing of tax administration in terms of functions are:

- ❖ Productivity increases due to specialisation in particular fields like assessment, collection, supervision and control and coercive collection. An officer does not have to know all the tax laws, or be responsible for tax assessment of the whole array of taxes relevant for a certain group of taxpayers in his/her competence. Special departments with specially trained personnel deal with new taxes and increased number of taxpayers. Lower rank personnel can perform routine jobs, while specialists can concentrate on more complex tasks.
- ❖ Possibilities for checking and control are better. When the same tax officer is not in charge of processing all the tax elements of one taxpayer, any mistake made in one function (for example, tax assessment) will be more probably discovered in another (such as, for example, control).
- ❖ Effectiveness of operation increases.

2.7.2. The influence of tax law complexity on tax administration

As has been mentioned in the preceding sections that any tax system should create certainty and should be simple in concept and in process of its collection. Certainty in this regard means that the taxpayer should be reasonably certain of what his/her tax liability would be in any given circumstances and simplicity requires that a tax should be easily assessed, collected and administered in order to minimise the costs of the tax to both the taxpayers and the fiscal authority (Gildenhuys, 1993:220).

If tax laws are composed in such an awkward manner that taxpayers can hardly understand them and tax administrations have a hard time implementing them, costs will increase. This entails more and more complex forms of tax evasion, causing increased costs of tax collection for the state and increased compliance costs for taxpayers. The cost of complexity is staggering. For instance before 1986 in US, individual taxpayers spent as much as three billion hours of their own time on tax matters each year. Many taxpayers bought books or computer software to help them. On top of that, about half of all individual taxpayers purchased professional assistance

from an accountant, lawyers or other advisors to prepare their returns. So the total cost of collecting tax including the value of those billions of hours that taxpayers might have used more productively, came to about US \$ 75 billion, which amounted to about 10 cents for every dollar of revenue raised. More sophisticated tax evasion, on its part, also influences the complexity of the system since it entails more detailed legislature to cover all the loopholes in the laws (Slemrod& Bakija, 1996:2).

2.7.3. Basic elements of tax administration reform

Tax reform in developing countries involves broad issues of economic policy as well as specific problems of tax structure design and administration. All these aspects are important, and none can be neglected. They are central to the problem of adequate revenue and help to match the revenue structure to development policy. This includes reconciling the impact of alternative taxes on saving and investment and their implications for the micro balance (domestic and foreign) of the economy. There is also the important goal of securing a fair distribution of the tax burden. Among more specific tax issues, attention needs to be given to composition of the tax structure as well as to the design of its major components (Musgrave, 2000:467).

The basic elements of tax administration reform should include the following requirements:

Firm and continuous political commitment- the process of reforming tax administration takes time and requires political support on the highest levels (Bird &De Jantscher, 1992:4).

A staff capable of concentrated work over a long period- Ministers of finance cannot be daily involved in issues and problems arising from tax reform. They must delegate to specialists some duties such as strategic planning, setting time limits for implementation, monitoring daily events, and decisions concerning transfer to less important jobs to less trained personnel and dismissal of any involved in corruption (Ott, 1998).

A well-defined and appropriate strategy- one strategy cannot be suitable for all countries. Reform of tax administration must be adjusted to local requirements such as a country's legal tradition in taxation, local traditions, available personnel and resources. Copying foreign of practices is a bad policy if insufficient attention is paid to own circumstances. The strategy chosen may be gradual or sudden, but it must definitely be simple and flexible, allowing deviations in the case of unforeseen events. It must also set forth priorities and deadlines (Bird & De Jantscher, 1992:4).

Personnel training and education- money is often spend in vain on extensive training. Instead of attempting to gain wide and general education, it would be preferable to narrow it down to

appropriate specialist qualifications, which are related to tax administration (Silvani & Radano,1992:36).

An adequate fund for tax administration or at least transfer of people and resources- this involves appointing people with adequate and differentiated salaries, and shifting employees from low to more productive jobs. Tax administration can be regarded in this respect like a business, which must maximise production, i.e. tax collection. The tax administration bodies must switch their organisation from being based on different types of taxes and taxpayers to being based on the key functions of tax administration (Ott, 1998).

Change in motivation of taxpayers and tax administration- there must be relevant programmes that deal with providing proper incentives for taxpayers and tax officials equally, such as motivating honest and hardworking employees by rewarding them through higher salaries and promotion (Schlemenson, 1992:361).

2.7.4. Main tasks of tax administration reform

The two main tasks of any tax administration reform are achieving greater effectiveness (capability to achieve a high level of tax compliance) and efficiency (capability to make administrative and compliance costs per unit of tax revenue collected as small as possible). The goal is to coordinate pursuit of effectiveness and efficiency because they can sometimes be contradictory. Government should take care not to pursue efficiency at the expense of effectiveness. Achieving the balance between efficiency and effectiveness or at least moving towards it is the goal of tax administration reform. It is useful, therefore, to point out special measures for the improvement of effectiveness and efficiency of tax administration (Tanzi, 1980: 10-11).

2.7.4.1. Improving effectiveness of tax administration

According to Silvani (1992:275), maintaining the maximum level of voluntary compliance is a reflection of the effectiveness of tax administration. The effectiveness of tax administration is measured by the degree of taxpayers' compliance with the tax laws, that is, the administration's capacity to enforce the tax laws. The effectiveness of a tax system is affected by administrative and compliance costs. The former is the portion of total revenue to be paid for the cost of collection that includes wages, salaries, and unpaid service received from other departments and full cost of accommodation and raw materials. This cost should be kept as low as possible. However, if sufficient resources are not available for enforcement, large-scale evasion and avoidance may take place resulting in a drastic drop in revenue. The compliance cost is the cost expended by the taxpayer in complying with tax law. This cost includes fees for tax accounting

and tax guides, time spent and psychic cost (stress). The onus of compliance rests on either the employers or the business enterprises or the taxpayer himself to calculate the liability and to pay the tax due to the receiver of the revenue. This cost should also not be excessive in order not to develop resistance (James & Nobes, 1978:39-40).

Effectiveness of tax administration can also be enhanced if the following factors are in place:

Voluntary tax compliance- The goal for voluntary compliance is to help taxpayers to know and fulfil their obligation at minimal cost. The primary goal of tax administration should be to bring about the highest possible voluntary tax compliance and this can be determined by looking at how the administration has employed its scarce resources in order to identify the instances of non-compliance and in taking appropriate action. Voluntary tax compliance can happen by minimizing the amount of overpayment made by taxpayers and this in turn increases the confidence of taxpayers in the tax administration. Voluntary compliance may also be encouraged, if the administration is successful in establishing the prospect that non-compliance will be detected and effectively punished (Bahl & Vazquez , 1992:102).

Principles of self-assessment and self-payment- These principles make effective tax administration and collection possible with a relatively small number of tax officers who have to cover a large number of taxpayers. This entails the empowering of taxpayers to assess and pay their tax liabilities according to prescribed procedures. But it is essential to lay down clear instructions and procedures and to provide sufficient encouragement in order to attain this objective. The tax authorities adopt a “*process now- check later*” approach to tax returns filed under the self-assessment systems. The information supplied in tax returns will be processed when the returns are filed and any obvious errors in taxpayers’ self-assessment will be repaired at any time in future (Melville, 1996:9).

Introduction of presumptive taxes- The hard-to-tax groups which include small retail establishments, professional people and farmers may be reached effectively by a presumptive tax. This approach determines the level of income and sales that may be imputed to a particular category and then imposes a tax on that basis. It is computed conservatively so as generally not to exceed the amount that would be payable under the regular tax (Musgrave, 2000:479).

Informing taxpayers- The taxpayers must be acquainted with basic knowledge in order to carry out thier own tax self-assessment and this can only be accessible to the taxpayer through taxpayers’ education. Tax administration must provide taxpayers with simple forms and clear and short information on tax returns. This is especially important when new laws are introduced (such as, for example, the introduction of value added tax), when significant resources and the

time of senior public officials, must be invested in explaining taxes and tax liabilities (Lebaube & Vehron, 1992:314).

Quick discovery of problems connected with tax returns and payment- It is extremely important for tax administration to discover taxpayers who have not filed tax returns (stopfilers), who miscalculated their taxes or were late in paying tax (delinquent taxpayers). Tax administration must make sure that appropriate steps are taken in such cases. If there seem to be too many unregistered taxpayers, an investigation should be started. Tax inspectors could go from door to door checking shops and handicrafts workshops for proper registration. They could also check records of registered taxpayers to discover suppliers and buyers who are not registered as taxpayers (Silvani & Radano, 1992:276-278).

Improvement in control and supervision- Taxpayers can evade taxes in ways that are difficult to discover. Thus more efficient control and supervision should be introduced. It is important that taxpayers believe that tax administration has complete control over everybody, including even the "biggest fishes". This will further stimulate their tax compliance. It should be suggested that inspection covers a far wider scope than it actually does. The programme must not be public and various circumstances may be given as reasons that might trigger control mechanisms. The control and supervision programme, however, must clearly define subjects, time and the extent to which control and supervision will go (Silvani & Redano, 1992:31).

Improving Audit Coverage- Non-compliance extends beyond stopfiling and delinquency to encompass fraudulent actions by taxpayers who understate their tax liability in different ways that cannot be detected during the collection process. In a modern tax system it is critical for taxpayers to believe that if they engage in such fraudulent actions there is a reasonable chance they will be caught and appropriately penalized. Also, it is important that taxpayers are confident that their competitors are paying the same taxes so they may compete fairly. This requires that an effective audit programme be carried out by the tax administration (Slemrod & Bakija, 1996:159).

Compliance depends to a significant degree on taxpayers' belief in the effectiveness of the audit programme. Further, the chance of being audited will appear greater, and compliance will be higher, if the actual details of the audit programme are not known. It is important that taxpayers should believe that a larger number of taxpayers are audited than is actually the case. This suggests a rationale for the tax administration not to disclose the information regarding its audit selection strategy and the number of taxpayers to be audited in a given period of time. Instead, the tax administration should promote the view that a variety of factors may lead to an audit. To

this end, the tax administration should show taxpayers that it has both the information and the capacity to detect violations (Ott, 1998).

Appropriate penalties- a tax system can function smoothly and yield anticipated revenues if there is an adequate system of penalties. As is contrary to the opinion that higher penalties entail less control, caution should be exercised here that penalties and control should be well coordinated. Too high penalties bring about, among other things, an inclination towards bribing tax officers. It is therefore deemed wiser to use lower, but visible penalties, such as closing shops, workshops or coffee shops for a few days or weeks than to charge high penalties. In very serious and repeated cases of tax evasion or non-compliances, highly visibility penalties such as the closing of businesses for a period are effective in addressing corruption. It is important to include interest provisions for late tax payment as compensation to the tax authorities for the time the taxpayer keeps the revenue. In this case the total interest cost should be more than the normal bank interest rate. If the penalty rate is smaller than the bank rate, it will be more beneficial to taxpayers to lend their money to others than to pay tax (Gordon, 1992:165).

Tax administration can be said to be effective if it is able to deal with the following key shortfalls (Silvani, 1992:275):

- ❖ *Unregistered taxpayers*-the first loss originates in the gap between potential taxpayers and registered taxpayers.
- ❖ *Stopfiling taxpayers*-the second shortfall reflects the difference between registered taxpayers and those who file returns.
- ❖ *Tax evaders*- the third is the difference between the tax reported by taxpayers and the potential tax according to the law.
- ❖ *Delinquent taxpayers*- the fourth and last gap is the one between the amount of taxes that the taxpayers report owing, or that the tax administration may eventually assess, and the tax actually paid by the taxpayers

2.7.4.2. Measures used to improve efficiency of tax administration

The level of enforcement of tax compliance at lower cost determines efficiency in tax administration. Efficiency is achieved when the administrative and compliance cost per dollar of tax revenue collected is relatively low. Efficiency reflects the actual costs of tax administration. Inefficiency of tax administration according to Tanzi (1991: 2), reduces tax revenue, creates distortions or non-neutralities in tax systems, and introduces different kinds of inequities through the tax system as for example between the honest citizen and tax evaders. In other words, tax

administration changes the ways in which taxation affects the objectives of government policy, namely the collection of revenue, fair allocation of resources, and economic stabilisation.

The main causes of inefficiency in tax administration are: tax laws themselves which appear to be complex and unclear demanding difficult information from the taxpayer; inefficiency also can originate from political systems where the policy-makers legislate and make decisions on the tax system in a biased manner. Other causes of inefficiencies originate from tax administration, especially the lack of a necessary degree of professionalism, and lack of a clear strategy of improving the efficiency.

Efficiency in tax administration is particularly stimulated by (1) establishing special units for the largest enterprises; (2) defining the minimum threshold for certain taxes; (3) alternate taxation for small taxpayers (annual payment, lump sum taxation or tax assessment on purchases); (4) taxation at source; (5) and outsourcing for example by using bank services for tax collection (IMF, 1996). Some of these efficiency measures support the earlier claim that a functional approach to organising tax administration is better than organising according to types of taxes. For example, the special unit can specialise across types of taxes and outsourcing can also be done according to functions.

Of the above-mentioned measures, the possibility of establishing special units for the largest enterprises, which account for a large percentage of total tax collection, should be specially emphasized. This entails the formation of Large Taxpayers Units (LTU). Such a unit should consist of leading experts in the field (highly professional and screened for corruption). It should control tax collection from the largest enterprises, which are small in number but nevertheless contribute the major part (sometimes more than 90 percent) of VAT and profit tax. The largest enterprises also contribute a significant amount of income tax paid by their employees (Bird & De Jantscher, 1992:56).

This special unit would guarantee timely collection of the greater part of tax revenue and also quick detection of unregistered and non-paid taxes, which would allow fast action and appropriate responses. It might also serve to redirect initial efforts in tax reform and to introduce more effective procedures for the most important taxpayers instead of dealing with a large number of small taxpayers, which bring smaller revenue.

According to IMF (1996), for an LTU to work properly, it must meet certain requirements (many of which are applicable to the overall tax administration). The requirements are:

- ❖ A sound legal framework;
- ❖ Clear and simple criteria for selecting large taxpayers;

- ❖ Standard and transparent procedures;
- ❖ LTU performance of all core tax administration functions;
- ❖ Clear reporting lines between the LTU and headquarters;
- ❖ Appropriate job grading and remuneration of LTU staff;
- ❖ Effective LTU staff training; and
- ❖ Identification and regular completion of key performance indicators.

In addition, a special unit for the largest enterprises usually includes both tax collection and supervision. Supervision is of special importance for a LTU because large enterprises perform a great number of transactions, have complex business operations, a number of organisational units (sometimes even in foreign countries), highly educated and experienced accountants and lawyers, all of which enables them to resort to forms of tax evasion which are difficult to discover. For the same reason, they also require a special control unit consisting of highly professional and capable personnel.

It is also essential to sustain the reforms introduced through the LTU, and incrementally extend the modernisation to the entire tax administration, including the tax offices dealing with small and medium-size taxpayers. But people should not overemphasize the administration of the large taxpayers while ignoring the medium and small taxpayers.

2.7.6. Tax evasion and avoidance

Administrative cost and compliance cost have a direct relationship with the other two problems in tax administration; tax avoidance and tax evasion. According to Slemrod & Bakija (1996:122), tax avoidance is defined as a legal manipulation by a taxpayer to avoid liability of paying tax through the loopholes found in the tax system. Some of these problems are supported by poorly drafted legislation. Tax evasion, in turn, is illegal and consists of actions that contravene tax laws. The most common forms of tax evasion are underreporting of income and claiming more deduction than warranted. Tax evasion is prevalent in the informal sector.

A good tax administration is, therefore, required to keep tax evasion and avoidance at a minimum level. For this purpose the golden rules in tax design are: simplification of laws and procedures; minimizing the incentives for tax delinquency; and penalties for tax evasion that are high and actively enforced (Melville, 1996:11).

Additional investment in tax administration is essential in order to have better means to prevent tax evasion. Expenditure on various customer service units, for example, may increase the costs of tax administration in the short run, but nevertheless reduce them in the long run. The

calculation behind this approach is that a greater number of taxpayers can be expected to hand in properly completed tax returns if they can get advice and help. This investment can thus be regarded as the means of increasing revenue because taxpayers' opinion of tax administration will improve and they will comply with their tax liability more willingly. For instance, about 800 million pounds was spent on the action to save resources in Great Britain in 1996. The greater part of the sum was earmarked for the prevention of tax evasion, but it was expected that about 200 million pounds invested in tax revenue offices would in the next three years return three times as much. Investments in tax administration increase revenue collection, particularly if accompanied by an improvement in the effectiveness of control and supervision. But it is particularly important to reduce possibilities for tax evasion by stimulating voluntary tax compliance among taxpayers (Ott, 1998).

The following sections elaborate on how the possibilities of tax evasion and willingness to evade can be reduced.

2.7.6.1. Lessening the possibility of tax evasion

According to the World Bank (2000), it is possible to lessen tax evasion if the following measures are in place:

- ❖ Collecting taxes at source (on salaries, dividends and interest) is the best solution. If that is not possible, a system of financial reporting should be devised which can be compared with tax declarations.
- ❖ The tax system should have as few exemptions, allowances and deductions as possible. Taxes should be selected which are more difficult to evade. VAT, for example, with its in-built control mechanism, is an example. It should, however, not have too many zero rates and different rates, which again increase tax evasion possibilities.
- ❖ Tax administration must be honest since a corrupt tax administration stimulates tax evasion. This calls for a simple tax structure where tax officers have minimum discretionary authority.
- ❖ Assigning a special tax number to each taxpayer has proved to be a useful device. Australia (where interest is taxable), for example, requires registration of one's tax number for every newly opened savings account. If this is not done, banks automatically deduct tax on interest at the highest rate. The same system is also in use in Latvia, where every taxpayer must be registered with the State Revenue Office and financial institutions are forbidden to open accounts either for individuals or companies without taxpayer numbers.

- ❖ Lower tax rates do not create incentives for evading. As Alan Tait, a leading expert of the International Monetary Fund, has explained: *“at 5 percent, the incentive to evade is probably not worth the penalties of persecution; at 10 percent, evasion is more attractive, and at 15-20 percent, it becomes extremely tempting.”* (Slemrod & Bakija, 1996:210).
- ❖ Reducing net profit gained by tax evasion. This net profit gained by tax evasion is reduced if the ratio between risk and profit increases. To achieve this, control and supervision need to be intensified by giving maximum publicity to tax evasion prevention, increasing fines and sentences, and publicizing at least figures if not names. Special attention should be paid to fines and sentences because overstressing them may lead to a feeling of resentment of tax administration and tax compliance.

2.7.6.2. Measures to reduce willingness to evade

Developing an increasing acceptance of taxation and tax administration, although slow, will reduce willingness to evade. This will be achieved if at least some of the following conditions are fulfilled.

- ❖ The state must create conditions for just and fair elections, equal implementation of laws for all, independence of courts, a cheap, quick and easily accessible system of complaints for everybody, and strong feelings of citizens' civic duty.
- ❖ People should believe in the fairness of the system. Distrust of the government is disruptive for tax compliance. If the state is perceived to be corrupt and wasteful (expensive buildings, cars, airplanes), if there is a conviction that certain ethnic groups and economic classes are fare better than other people in the distribution of state funds and that taxation is not sufficiently vertically or horizontally fair, citizens are likely to stop believing in their state. The state must be seen to be just and fair. Lawbreaking and all violations must be punished severely. The state should report to the public regularly and in detail about its expenditures and any change in tax policies (Ott, 1998).
- ❖ Forming good relationships between taxpayers and administration should be formed through special customer services units and small business units. These services should be designed so that they will increase the awareness of the needs and problems of the customers. Taxpayers should be approached as clients to be given assistance and innocent until proven guilty. Such special services for help, information and education increase the taxpayer's trust in the tax system. Moreover, they lead to reducing compliance costs and improving the level of tax compliance. Information should not only be given through the media, but in various publications, by phone, and in person.

Systematic, simple and understandable literature on the tax system, allowances, and detailed instructions on completing and filing tax return are imperative, together with direct help provided in completing tax returns (Lebaube & Vehorn, 1992:310).

But it is difficult to have a complete non-evasion taxation system in any country. According to Bahl and Vazquez (1992:98-99), tax administration in some developing countries may be weak because governments have deliberately chosen not to make it stronger. Total enforcement of tax compliance to obtain adequate tax revenue is only one of the objectives of governments. Other objectives, such as protecting citizens' right to privacy or their right to due legal representation and procedures, also have to be weighed in order to indicate how far to go in tax enforcement. At the same time after a certain level of enforcement is reached, the administrative costs of raising any further revenue are likely to exceed any additional taxes collected.

2.8. CORRUPTION IN TAX ADMINISTRATION

Corruption is a pervasive problem in many developing countries, and revenue administrations are often perceived to be among the most corrupt government agencies. The World Bank (2002) defines corruption as “*the abuse of public office (with its associated resources and power) for private gain or the benefit of a group to which one owes allegiance.*” Corrupt actions include various two-or multi-party transactions in which the beneficiaries are willing to bribe an official, as well the bilateral theft of public property by its steward. Corruption can exist at all levels of public office, which ranges from the highest political level to the lowest functionaries.

Corruption plays a negative role in the tragic economic and social degradation of a country in general and leads to heavy loss of revenue, on the one hand, and harassment of the taxpayers, on the other hand.

The sections that follow address the causes of corruption and strategies followed to combat it.

2.8.1. Causes of corruption in tax administration

The causes of corruption are similar in most developing countries. They are poor compensation, high discretionary powers, lack of accountability, greed, societal pressure, and complex and cumbersome procedures. Poor compensation is the main cause of corruption in most countries. Every one wants to earn an honest living but the governments may force people to be corrupt by not providing them with decent wages and operational expenses. The second most frequently cited cause of corruption is the extensive discretionary powers the tax collectors possess. This is made even worse in the absence of any meaningful accountability of tax collectors who are guilty of improper behaviour towards the taxpayers. The revenue agency can fix any income or refuse any expenditure at its whim. If taxpayers appeal they can lose their precious time and

money. Some times the accuser and the judge are the same person and it is difficult to get a fair solution in such circumstances (Girling, 1997:20).

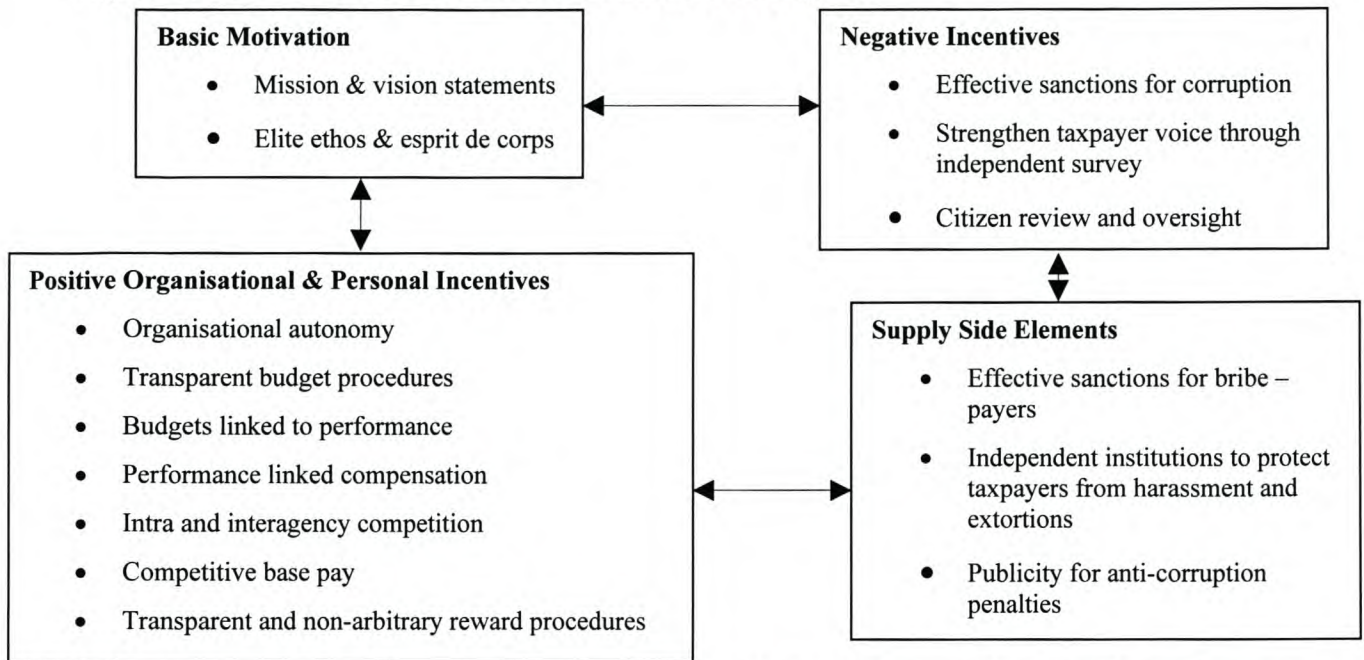
In addition, corruption in tax administration is a two-way street. That is, for each corrupt tax agency employee, there is a corrupt private sector person who is indulging in corruption either willingly or under duress. Some of the reasons put forward by the private sector for non-payment of taxes are (Mauro, 1996; World Bank, 2002):

- ❖ Firstly, a large majority of the private sector justifies non-payment of taxes because of the dismal or simple non-performance of the government in its duties. People complain that the government is wasting their money. People will not be ready to pay taxes if the government is not fulfilling its contract to ensure the provision of a decent quality of infrastructure such as health, education, social security, roads, and above all security of life and property.
- ❖ Secondly, lack of tax culture or education is another cause of corruption in the private sector. There are no means by which people can understand the taxation system and this in turn renders the tax system complex to people who are forced or tempted by tax administrators themselves into not paying the correct amount of tax.
- ❖ Thirdly, high taxes also lead to corruption or massive tax evasion.
- ❖ Fourthly, greed and lack of accountability are other causes of corruption by the private sector. When people see leading businessmen and rulers getting away without paying any taxes, they feel they can try the same. If higher classes do not pay taxes and get away with it without any measure against them, then why should the middle class and lower class pay taxes? Businessmen who do not pay taxes can out compete those who do. So everybody is attracted to corruption and the evasion of taxes if the opportunities to collude are everywhere.

2.8.2. Anticorruption strategy in tax administration

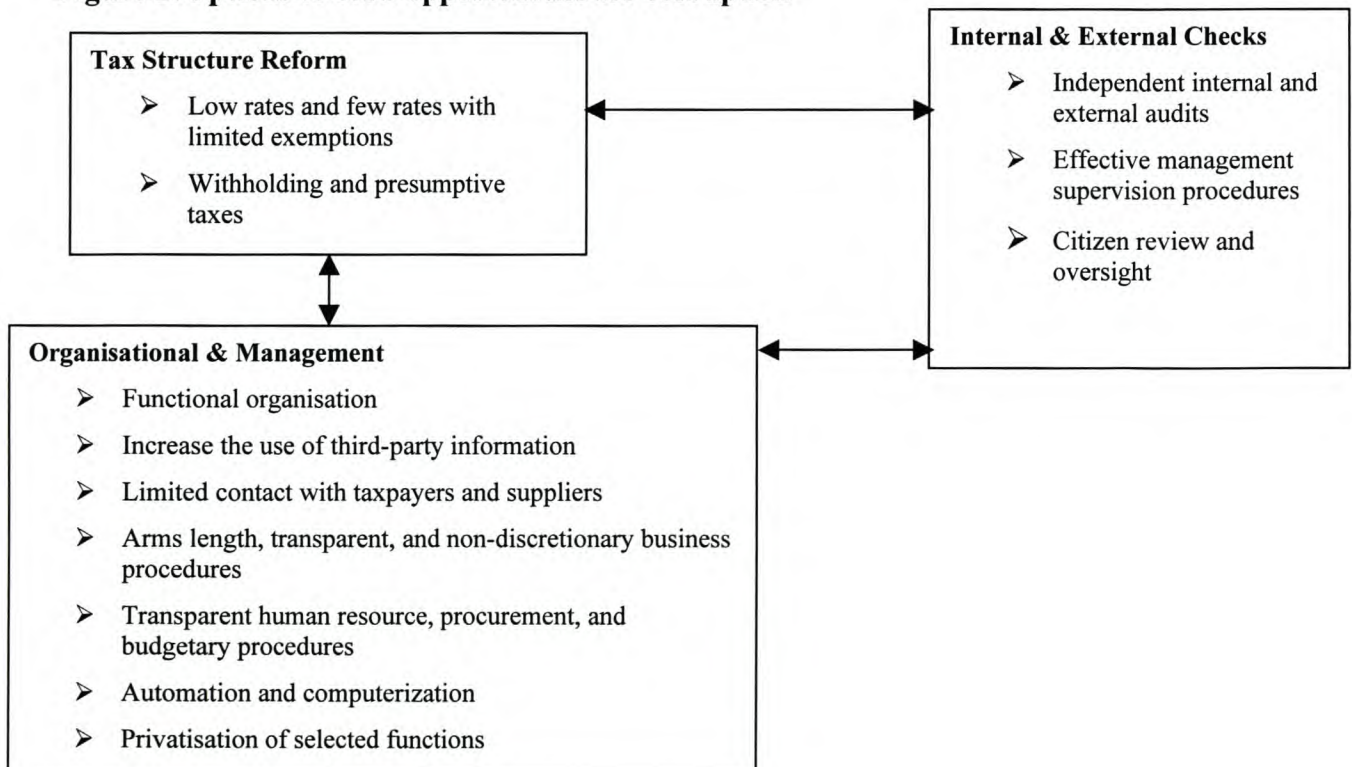
According to Asher (2001), any strategy that hopes to combat corruption ultimately must diminish both the motive (i.e., the incentive) and opportunity of public office holders to abuse their position for personal gain. It is essential to identify “optimal” anti-corruption strategy mixes for different countries’ situations. That is, a “one-size-fits-all” strategy does not exist. Various elements from the menu of possibilities must be integrated into a coherent package. The menu of reform choices to alter the incentives for revenue officials to engage in corrupt behaviour are divided into four categories as shown in Figure 1.

Figure 1: Reform choices to address motives for corruption



Sufficient organisational autonomy of the revenue administration, combined with performance-linked budgets is often advocated as an effective way of achieving efficiency. At the same time competitive base pay and non-arbitrary reward procedures are also widely advocated. Moreover, negative incentives must complement the positive incentive system to deter corruption and increase the will of officials to work hard. On the other hand, elements that address incentives alone are, in practice, insufficient to hold back corruption. Opportunities for corruption also need to be curbed. The list of options is given in Figure 2.

Figure 2: Options to curb opportunities for corruption



Perhaps the most important method of limiting opportunities for corruption is tax simplification, which also leads to improved economic efficiency. Tax reform should generally focus on rate reduction, tax-base broadening and the elimination of special exemptions. Such reforms tend to make tax obligations transparent and reduce the compliance cost of honest taxpayers. Presumptive taxation on small businesses, which may not keep sufficient books and records, can also reduce the discretionary power of tax inspectors and make tax calculations simpler and clearer. In addition, organisational and management reforms that can form part of an anti-corruption strategy include clear division of responsibilities along functional lines and transparent, written procedures. But their effective implementation depends on the state of the development of the tax administration and the economy at large. An internal audit division and anti-corruption units are the most important anti-corruption institutions within revenue administration. There are also important institutions outside the revenue administration which include an independent and effective judiciary, external reviews by government agencies, such as an independent external audit and taxpayers' associations that strengthen citizens' voice. Finally, to limit the excessive contact between the taxpayers, tax officials withholding taxes, extended use of third party information for tax assessment, automation of procedures and privatisation of selected functions are important instruments to fight corruption (World Bank, 2002; Cheema & Bonvin, 1997).

2.9. OTHER MEANS FOR ENHANCING TAX ADMINISTRATION

Tax administration could further achieve its goals if it focuses on issues such as taxpayer assistance, organisational structure, human resource and information management.

2.9.1. Assisting taxpayers in meeting their obligations

According to Lebaube and Vehorn (1992:310), a judge in a tax dispute once remarked "*the art of taxation is so plucking the goose as to get the feathers with the least hissing.*" The judge's observation illustrates the basic reason why governments need to assist their citizens in meeting their obligations under their nation's law. The logic is that if the goose understood the need to give up some of its feathers and knew the least painful way to perform the removal, it would not hiss too much. So, this shows that it is the obligation of the tax administration to provide taxpayer service, which includes assistance, information and education so that the taxpayers will be conscious of their obligations.

The rationale behind providing taxpayer assistance is that some tax laws are complex, contradictory and hard to interpret, even hard to find; the necessary forms are hard to locate; forms and payment have to be submitted at inconvenient times and places; and those who

become involved with tax officials feel annoyed and harassed. Therefore, taxpayer assistance is needed to improve tax administration performance in the areas of clarity, access, and education. The main taxpayer service functions deal with compliance with law, problem resolution and dissemination of information (Lebaube & Vehorn, 1992:314).

Compliance with law- Citizens must have the means to understand what is required from them in order to comply with the law. This may entail such programmes as developing clear forms and instructions; providing points of contact with citizens so that they can request and secure information about their duties; and developing educational programmes to inform existing and future taxpayers.

Resolution of problems- No matter how well (or poorly) citizens comply with laws, errors occur. So the tax administration must have avenues for citizens to contact and deal with government. The success or failure of these contacts can determine to some extent the level of confidence citizens have in their government. It is also important for the tax administrators to be responsive, polite, and willing to apologize if the error is on their part.

Dissemination of information- A primary element of taxpayer service is to inform the public of their duties and responsibilities under the tax laws. It is essential that tax administrators provide information such as rulings, regulations, decisions, and other notifications to foster high levels of compliance and to minimise problems.

According to Lebaube and Vehorn (1992:316-326), there are many types of taxpayer information programmes available to taxpayers throughout the world. The main ones are publications, media, telephone contact, personal contact, correspondence and other programmes.

Publications include tax guides, pamphlets and bulletins, technical publications, audiocassettes, newspaper tax supplements and reminders in the press. The media can make use of radio or television commercials, special television programmes, video cassettes and press conferences.

Some taxpayers use the services of private paid preparers and this personal choice may be a reflection of distrust in the system, complexity in the tax laws, or just no desire to do it themselves. But there are also other programmes that can reach many people and serve certain elements of the population who can neither afford preparers nor are able to perform the task of filling in returns themselves. This includes the recruitment of volunteers by the government and the introduction of courses related to taxation in schools. The volunteers may be from various walks of life, such as accountants, retirees and other persons interested in helping those unable to help themselves.

2.9.2. Organisational structure and human resources in tax administration

In addition to what has been discussed earlier, achieving good tax compliance also involves a variety of factors such as the tax administration's image, its employees' credibility and their readiness to serve. In this section there will be an emphasis on two other fundamental factors that affect the efficiency and effectiveness of any organisation. They are organisational structure and human resources. These two features are the foundations of any organisational development (Schlemenson, 1992:343).

2.9.2.1. Organisational structure in tax administration

Organisational structure is the formal framework required for an organisation to operate as an integrated system that processes information and solves problems. Delineating the responsibilities of each area and its constituent roles and correctly defining the interrelationships among these roles facilitates harmonious operations and allows the entire organisation to work toward a common goal. The confusion generated when the responsibilities of various roles are poorly defined impairs the functioning of an organisation. Designing an appropriate organisational structure therefore helps to reduce ambiguity and to increase productivity. Employees also benefit from a coherent set of rules because they know exactly what is expected of them and what objectives they are supposed to meet.

According to Schlemenson (1992:344), organisational structure encompasses the definition of (1) an organisational chart;(2) the mission and functions of the organisation and of its various constituent areas and roles;(3) the formal mechanisms linking these areas and roles;(4) the scope of the authority of each role; and (5) the hierarchical level.

Vertical fragmentation is one of the problems that affect the line of command in most organisations. Line of command is composed of the higher levels which plan and direct, and the operating levels which are responsible for implementing the plans. It is common that the relationship between the "advisory or regulatory" areas, on one hand, and the "operating or line" areas, on the other hand, are subject to imprecision and contradictions. This is reflected with respect to the authority of each area, the power of command of the former over the latter areas and the exercise of control. It is apparent when there is a significant degree of ambiguity in boundaries that separate these areas. But the need to define a clear line of command also presents a new problem. At the higher level the principle of specialisation predominates (collection, audit, technical and legal affairs are specialized areas) but at the regional levels these functions are integrated under a common authority. Thus, the break of the line of command is basically due to two reasons: (1) when the operating unit managers do not officially report to the advisory and planning areas, from which they nevertheless indirectly receive instructions and (2) the

advisory areas are divided by specialisation while the operating sector is integrated under a single versatile role in which regional managers through their subordinates take responsibility for all functions. These contradictions give rise to situations of multiple authorities and split responsibility.

Another problem in organisational structure is horizontal fragmentation, which is defined as the lack of integration among offices or regulatory areas at the organisation's higher levels. Although lack of integration is more prominent in the three basic areas namely collection, audit and technical and legal, it affects all the directorates of tax administration organisation. Thus, the areas behave internally as if they were independent and isolated organisations. Each has its own systems, organisational forms, operational technology and organisational culture. This in turn leads to a fragmentary relation with the taxpayers.

Schlemenson (1992:363) proposed solutions to the above-mentioned problems. The first is to increase vertical and horizontal integration mechanisms through unified strategic planning systems that ensure the participation of the various areas at the top of the organisation. This will be helpful if functions such as collection and auditing are put under a single directorate of operations to which specialists working in each of these system report in the capacity of advisors. The second suggested solution is that the lines of command should be clarified.

2.9.2.2. Human resources management in tax administration

The management of human resources is the fundamental pillar in all organisations. Employees are most important in determining the effectiveness of any organisation. Greaney (1992:367) put it even more strongly when saying, "*the organisation is only good as its people.*"

To establish a consistent human resources policy, it is necessary to differentiate between three basic variables that should be in equilibrium, as well as to understand the importance of interrelationships among them in the dynamics of the organisation. These three variables are (1) the complexity of the role and the tasks performed at a given level; (2) the individual ability required to do the job; and (3) differential compensation. In practice these variables are usually not in equilibrium and this often results in workers' dissatisfaction. In addition, the work itself and the opportunities it affords for the exercise of individual ability and judgment, and further development, advancement and career opportunities affect employees' satisfaction (Schlemenson, 1992:358).

Excessive, centralized prescriptions of system regulations and procedures restrict autonomy of action and can for this reason produce dissatisfaction among employees at the lower levels in the hierarchy. For example, tasks in collection are more highly regulated owing to the centralized

nature of the system and regulations. They are simpler, more elementary, and more routine and as result, duller and more tedious for the employees. The perspectives for the full development of employees' abilities, knowledge and experiences is limited in the tax collection area. In contrast, audit tasks offer a chance to observe broader, more complete processes requiring analysis, collection and interpretation of data that need more mental operations and that give greater autonomy and therefore provide a higher degree of satisfaction. The professionals in the audit division can get opportunities to be trained in technical aspects of taxation that will allow them to opt for well-paid jobs in the private sector.

Many tax administrations experience problems in connection with salary levels. For instance, the salary difference between the management position and an advisory position is not very great. Again "incentive funds" in most developing countries do not function as real incentives to boost productivity. Employees assimilate these funds with the general concept of compensation because these incentives do not discriminate on the basis of individual performances. This cannot simply be achieved by increasing salaries but it requires revising the wage policy by which the internal system pays the most productive and penalizes the most unproductive (Schlemenson, 1992:360-363).

2.9.3. Information management systems in tax administration

According to the World Bank (2002), in order for information to be used to the maximum possible extent it needs to be managed from all relevant perspectives and used as a shared resource in any organisation. Data must be shared, not duplicated, and the collecting and maintaining entity must serve as the "steward" for this commonly used asset of the organisation as a whole. So the Management Information Systems (MIS) division would be responsible for data entry, processing, storage, upkeep, access, and security of all databases. The computer based information technology system that people envisage would be networked and should have the following features and capabilities:

- A unique tax identification number that would identify each taxpayer;
- On-line access from any point in the network to the centralised database;
- Ability to enter, process data, correct arithmetic errors, generate notices, and compute taxes and penalties;
- Track tax collection and arrears, incorporate appeal effects, and monitor payment of refunds;
- Handle electronic filing of returns; receive information electronically from banks, employers, and withholding agents;

- Integrate sales tax, income tax, withholding tax, and customs information through a common tax identification number;
- Allow access to database on property transactions and major expenditures of taxpayers; and
- Generate statistical information for policy analysis.

2.10. SUMMARY AND CONCLUSION

Tax is defined as a nonpenal act and compulsory transfer of private resources to the public sector. Tax is the principal source of finance to all governments in addition to user charges, administrative fees, consumer tariffs, borrowings and printing money as alternative sources of funds.

Taxation serves three main functions, which are revenue, wealth and income redistribution and economic stabilization. In addition, taxes are categorized into income, wealth and consumption taxes. Income and consumption taxes are taken from the flow of value whereas wealth taxes are taxes on accumulations. On the other hand, income and wealth taxes are direct taxes while consumption taxes are indirect taxes.

Income is commonly defined as the money value of the net growth to one's economic power between two points of time. In some countries for the sake of taxation income is classified as personal, corporate (company), payroll and turnover.

Consumption taxes are intended to be borne by consumers and are dependent upon retailers acting as tax collectors. Examples of consumption taxes are general retail sales taxes, VAT, excise duty, import duties, export duties, and surcharges on imports. VAT is found to be simpler to administer and to enforce compared to retail sales taxes. Although consumption taxations yield a great deal of revenue, they do not take personal circumstances into consideration.

The issue of equity is essential in a taxation system. The two main principles of equity are benefit-received and ability-to-pay. The former principle stipulates that the tax burden should be in proportion to the benefit each taxpayer gains while the latter stresses that people should contribute to costs of the government in line with their financial capabilities. The ability-to-pay principle includes the horizontal and vertical equity rules. Horizontal equity calls for equal treatment of equals while vertical equity requires an appropriate differentiation among unequals.

In addition, for a taxation system to be acceptable it should fulfil the criteria of fairness, certainty and simplicity, convenience, efficiency and effectiveness, visibility, productivity and neutrality.

The new trend in tax administration reflects a need for greater independence and the privatisation of certain activities. Tax administration practices should be similar to those of private financial institutions with more autonomy and separate budgets in order to retain and attract young professionals.

Generally, the main functions of tax administration are facilitating tax compliance, monitoring compliance and taking strict measures against non-compliance. Moreover, tax administration should be considered as a production unit that has to collect taxes and as a service unit that provides a sound link between taxpayers and tax administration.

There is also a need for a continuous reform of tax systems and tax administration. The basic requirements for such reform are continuous political commitment, capable staff, well-defined and appropriate strategy, training and education, adequate funding and the introduction of change in motivation of taxpayers and employees.

Generally, the ultimate goals of tax administration are to achieve higher effectiveness and efficiency. That is a tax administration is said to be effective if it is able to achieve the objectives of a given tax system. In other words, tax administration is effective if it is able to reduce the cost of administration and compliance as far as possible.

Effectiveness of tax administration can be enhanced through voluntary compliance, introduction of self-assessment, taxpayer's education, prompt detection of tax filing and payment procedures, increased control and supervision measures, improved audit coverage and the application of proper penalties.

Inefficiency is caused by tax laws themselves, the political system, lack of professionals and lack of the proper strategy to use the available resources optimally. This can be treated by establishing special units for the large taxpayers, assigning minimum thresholds for certain taxes, applying alternative means of taxation, using banks to collect taxes and collecting taxes at source.

Tax avoidance and evasion are also two important issues in tax administration. Tax avoidance is a legal manipulation by taxpayers to avoid tax liability through loopholes found in the tax system, whereas tax evasion is illegal and consists of actions that breach tax laws completely. Tax evasion can be reduced by collecting taxes at source; having few exemptions, allowances and deductions; assigning special identification numbers; lowering tax rates; having honest staff and reducing the net benefit gained by evasion. At the same time it is possible to lower the willingness to evade if there is fairness in government and if there are special customer services that assist taxpayers to meet their obligations.

Corruption is another undesirable phenomenon that prevails in most developing countries' tax administration offices. Corruption is defined as the abuse of public office for private gain. It is mainly caused by poor compensation, high discretionary power, and lack of accountability, greed, societal pressure and complex and cumbersome taxation procedures. The main strategies for curbing corruption are focused on diminishing the motives and opportunities that lead to corruption.

Taxpayer assistance services are needed to improve tax administration performance in the areas of clarity, access and education and these in turn will enhance the consciousness and willingness of the taxpayer to fulfil their obligations. These services deal with compliance with law, problem resolution and dissemination of information. This can be done through publications, media, telephone, personal contact and correspondence.

Furthermore, organisational structure and human resource management are also two basic elements in any organisation. The organisational structure is the formal framework required for an organisation to function as an integral system. It covers the definitions of an organisational chart, vision, mission, and formal mechanisms, scope of authority and the hierarchical level. In addition, the administration of human resources is also another fundamental issue that needs great attention. This is true because employees are the main resources in determining the effectiveness of any organisation. This, therefore, requires the establishment of a consistent human resource policy which deals with roles and tasks of people, individual ability and differential compensation systems.

In addition, management information system (MIS) is another important aspect in tax administration. It deals with data that must be shared without being duplicated among all concerned bodies.

Chapter Two presents the theoretical background of taxation and tax administration and it will be used as a springboard for the whole thesis. The following chapter discusses some of international tax administration issues and the experiences of some countries in dealing with taxation.

CHAPTER THREE

3. BENCHMARKING TAX ADMINISTRATION ISSUES

3.1. INTRODUCTION

This chapter advances main tax issues highlighted during the theoretical discussion of Chapter Two further by explaining the positive experiences of selected countries in dealing with these issues as benchmarks. This chapter discusses tax administration reforms initiatives and the role of technology and information management as seen in the experiences of Bolivia, Jamaica, Guatemala, Croatia, Spain and Singapore.

3.2. SOME INTERNATIONAL SUCCESSES IN TAX ADMINISTRATION REFORM

This section discusses tax administration reform successes in Bolivia, Jamaica, Guatemala, Croatia, and Singapore. It outlines the strategies aimed at enhancing revenue collection through structural reform, tax system changes and modernisation.

3.2.1. Bolivia

In 1985 Bolivia faced a serious political and economic situation during which the inflation rate was high. Before 1985 the tax system was chaotic, with more than 400 separate national, departmental, and municipal taxes. Taxpayer registers were completely out of date, and tax collection record keeping was delayed and data processing virtually non-existent. Thus, the total amount of tax collected dropped to one percent of GDP in 1985. The new government of Victor Paz Estenssoro therefore launched a new economic policy. The new policy freed large areas of the economy from official controls, with the exception of prices of fuel, public services, and pharmaceutical products. In addition, public sector salaries were frozen from August 1985 to December 31, 1985 (Silvani & Radano, 1992:23).

Once the reform was enacted, the great challenge lay in reorganizing tax administration. A comprehensive plan was drawn up for this purpose. The plan incorporated restructuring of the administration; the design, development, and implementation of its principal systems; and the training of personnel to operate those systems. In order to attain these ends and to be successful, the new government of Bolivia took four measures: (1) it established a temporary ministry of taxation which was charged with the responsibilities of drafting regulations to cover all the taxes enacted under the new tax reform law and with leading the whole process of change in tax administration; (2) it hired a team of international consultants of whom some were specialists in

tax administration and others in computer systems to design, develop, and to put in place the new system; (3) it adopted political decisions with firmness and abided by the deadlines set for developing the systems and making them operational without becoming impatient or resorting to quick-fix solutions; (4) it delivered the resources needed for the team of consultants to do their job effectively on time (Silvani & Radano, 1992:24).

These administrative and procedural changes were applied to all taxpayers, which resulted in Bolivian performance of revenue to GDP ratio rising from 1 percent in 1985 to 7.4 percent in 1990. Other major factors that contributed to successes of the reform efforts in Bolivia included strong international support (IMF, CIAT, IDB), timely government responses to make available resources, speedy promulgation of appropriate tax legislation, and the strategies employed against resistance to changes, the appointment of teams of like-minded specialists and the absence of interference from the government or from the international agencies (Silvani & Radano, 1992:20).

Some of the initiatives that were taken by Bolivia to reform tax structure, administration, codes and special operations are discussed in the coming sections.

3.2.1.1. Reforms in tax structure, administration and tax code

In order to replenish government coffers, the choice of tax system fell on a simple tax system with moderate rates that would not distort the allocation of resources within the economy. At the same time special decrees were enacted to include the greater Bolivian population which were engaged in small commercial and service activities (informal economy) at the retail level in the new tax system. People in this informal sector were divided into categories with appropriate tax forms bearing a pre-established value applicable to each category. These tax forms were simple and supported easy tax compliance (Bejakovic, 2002).

The most important changes in the Bolivian tax code were: (1) introduction of fines ranging from 50 percent to 100 percent of the unpaid taxes when tax fraud is committed;(2) provision of jail terms for tax fraud;(3) cancellation of registration in public register when tax fraud is carried out;(4) introduction of penalty of temporary closure of establishments;(5) provision for automatic indexing online with changes in the official exchange rate of the US dollar for outstanding tax debts as well as of the credits; and (6) provision for interest on delinquent amounts to accrue automatically for the amount of the unpaid tax (Silvani & Radano, 1992:27).

Furthermore, there were significant changes in the basic system and procedures. For instance, it was decided to launch a general registration of taxpayers. By December 1991, the number of registered taxpayers in the new system reached 365,555. At the same time, return forms were

designed in a simple manner and each form never exceeded two pages. The tax return forms served as payment form as well. Since May 19987 it also became possible for the taxpayers to file returns and make their payment at banks. These simplifications freed the General Bureau of Internal Revenue (DGRI) from the heavy workload of processing payments and tax returns. As a result of these new changes, the average monthly amount of tax returns and payment processed by the new system reached 190,000 in 1987(Silvani & Radano, 1992:29).

A new system of control of tax returns was started to detect taxpayers who had not discharged their obligations to file returns and that enabled the tax administration to make a selection among them according to various criteria (by region, tax, taxable period, presumed tax importance). The system allowed issuing orders to file any missing tax returns and each was supplied with a return stub for notice of delivery. Taxpayers who persisted in not filing a return after being ordered might be forced by law to make a partial payment of an amount similar to the largest tax reported or determined in the immediately proceeding 12 months. The new system also allowed reviews of tax returns to determine whether the arithmetical calculations of the taxpayers were correct and to make sure if any applicable fines had been included in the event of late filing. Such technical errors dropped from 22.6 percent of all tax returns in 1989 to about 9 percent by March 1991(Silvani & Radano, 1992:30).

The only tax that might be paid in instalments was the tax on presumed corporate income. The new law provided that 30 percent of this tax might be paid as a down payment and the balance would be due in up to ten equal consecutive monthly instalments. But these regulations were later supplemented by an administrative ruling that could void this type of payment plan if necessary.

The new system made it possible to monitor tax compliance by the largest taxpayers and choices of cases to be audited was always made objectively, and discretionary selection was rare. A special system was designed to monitor the taxes on motor vehicles, motorboats and urban fixed property. For these taxes, tax returns were sometimes distributed along with major newspapers in the main cities. At same time tax statistical files were generated for internal use and for use by other government agencies. Again, the special record and invoicing rules required that for the invoice to qualify as a tax note it had to be validated with a seal by DGRI before being used by the party making the sale.

3.2.1.2. Special operations to increase tax collection

Throughout the period when tax reform was being implemented a series of special programmes were conducted for increasing tax collection. The main operations carried out were (Silvani & Radano, 1992:34-35):

- Control of taxpayers subject to the tax on specific consumption;
- Monitoring of public companies, public agencies and municipalities;
- Control of tax compliance by banks (filing of tax returns and payment);
- Making sure that public and private companies correctly withheld amounts due under the VAT system;
- Cross-checking of tax notes;
- Managing of tax return filing and payment by self-employed professionals; and
- Temporary closure of business establishments.

Temporary closure of business establishment was the most spectacular operation of all. It consisted of shutting down for a minimum of seven days the establishments that did not issue a proper invoice to buyers. The operation was carried out by groups of two inspectors from the DGRI and two policemen, who asked persons coming out of stores to show them the invoices for purchases. If an invoice had not been issued, the group would record the establishment for sanctions.

3.2.2. Jamaica and Guatemala

The pre-reform tax administration in Jamaica and Guatemala was characterized by an acute shortage of skilled staff. In both countries one of the reasons for the staffing problem was low salaries, even given the job security and prestige that a government post might offer. There were no formal career development programmes and the opportunity for promotion was limited. The methods used to assess and collect taxes were also inadequate. There were no unique numbering systems for either businesses or individuals; hence there was no up-to-date master file of taxpayers. The systems were completely manual. The tax file rooms were inadequate in size and files were regularly misplaced or lost and records were frequently out of date or incomplete. There was no monitoring of the performance of the tax system. Furthermore, there was no annual statistical volume reporting the distribution of taxpayers and revenue forecasting model (Bahl & Vazquez, 1992:68).

In order to address the above-mentioned issues, the government of Jamaica implemented a major reform of its tax administration in 1986-87. The tax reform was comprehensive and included the restructuring of all taxes and the improvement of tax administration. There was heavy investment in tax administration, including a comprehensive training programme, significant progress in computerization and the establishment of a revenue board. The revenue services were reorganised to execute its functions in a better and integrated manner. Extensive training

programmes for revenue agents were introduced; a number of courses for income tax assessment and collection were concluded; and computerization of the revenue services was well under way. The reform package in Jamaica was a success because it was popularly accepted. The revenue targets were met and there were no major incidents in tax administration because the tax reform was preceded by a careful evaluation of the existing problems, qualification of the tax system, and the simulation of the impact of possible changes. The proposals were subjected to public debate, deliberated upon by a commission and reported in the media. As a result of those efforts, the tax administration started to concentrate on enforcement of the system, and therefore there was a marked increase in the number of employer and individual returns (Bahl & Vazquez, 1992:68-69).

Unlike Jamaica, the 1983 Guatemala tax reform was carried out almost in an *ad hoc* fashion. There was no revenue board, no training plan and no consistent, long-term programme for improving tax administration. In other words, tax reform was preceded by little preparation, especially for the introduction of VAT. The government could also not afford the time to do it right. In addition, only a few Guatemalan experts were involved and little international expertise was used in assessing and formulating policy. Rather than public debate, there were a number of presentations to the public through the media and public meetings. Consequently the government was not in possession of the necessary background information and there was strong opposition from the private sector against the implementation of 10 percent VAT. Tax reform in Guatemala initially increased the central government share of GDP from 8.9 percent in 1986 to 10.1 percent in 1988. However, revenue declined to 9.1 percent of GDP in 1989 and further plunged to 6.5 percent of GDP in 1990 (Bahl & Vazquez, 1992:69-83). It seems that a well-planned approach allowing for proper public buy-in is essential for success.

3.2.3. Croatia

Contemporary tax administrations tend to more taxpayer-centeredness, to employee specialisation, to independence of the finance ministry and the privatisation of those activities that can be best handled by the private sector. Croatian tax administration reforms were set in motion to realise these ideals. In these reforms certain of the key problems were addressed, such as low wages and the consequent difficulties of attracting quality staff, corruption, and the complexity and opacity of the tax laws. There was special focus on: functional organisation of tax administration; the establishment of special services to communicate with taxpayers; the setting up of special branches for large taxpayers; the reduction of tax revenue collection costs; and the prevention of tax evasion (Arbutina *et al.*, 2002).

As the work of a modern tax administration is complex, it is necessary to pay constant attention to improvements in the quality and competence of officials. For that reason the Croatian tax administration inaugurated special tax studies at the Zagreb Faculty of Law in the 1990's. In addition, the tax administration set up a post-graduate course in public finances, provided through on-going in-service training for officials for given jobs, and care was taken to hire and deploy officials with training in law and economics. The intention was to improve the quality and expertise of employees (Ott, 1998).

Although the Croatian tax administration was not independent in 1997, it did not seem desirable to recommend it being taken out of the Finance Ministry. The tax specialists recommended that it would be sufficient to develop independence within the context of that ministry, with greater emphasis on financial independence. So the tax administration was able to retain in perpetuity a certain percentage of the tax collected so that it could independently set its pay scales and incentives, and so that it might invest in better education and set up a special fund for result-related incentives (Bejakovic, 2002).

After reviewing the long-term benefits, it was also recommended that there should be privatisation of those activities that the private sector could do better, for example, computer systems, publishing and sending out of tax forms, and reports about taxes paid, communicating with taxpayers and the like. However, care was taken for privatisation not to result in any practices detrimental to the public and to tax administration (Bird & De Jantscher, 1992:377).

Before the reform the average wages in the tax administration had lagged behind salaries in the private sector, as well as behind other wages in the public sector. To address that problem initiatives were taken to give employees in the administration more motivation through pay rises, further training, promotions and impartiality in hiring policy.

As current best practices of orientation towards the taxpayers suggest there is a need to set-up special services for interacting with taxpayer. It was suggested that such services should be developed as soon as possible in Croatia. To begin with, these services were introduced in the central office, and afterwards, at other levels as well. The task of the service was at first mainly, to instruct citizens about how to fill in and submit their tax returns. The introduction of such services helped to achieve better public relations, increased trust in the tax system, and in the work of the tax administration, reduced compliance costs, and made the whole procedure simpler. The most capable and experienced employees were deployed in this service, and they were specially rewarded in order not to be tempted to submit to any bribes they might be offered by the large taxpayers (Lebaube & Vehron, 1992:314).

3.2.4 Singapore

When Singapore became an independent Republic in 1965, the country's revenue structure and administration were similar to those of many other former British colonies. But in 1992 a new statutory revenue authority, the Inland Revenue Authority of Singapore (IRAS), was created and became responsible for administering income and property taxes, as well as the new value-added tax. Over the years between 1992 and 2000, a completely new administrative system was introduced in a carefully phased, step-by-step fashion (Siew & Boon, 1998:496-514).

The studies on tax administration showed that every year the tax authority accomplished only half of its workload. At the end of 1990 the authorities had yet to settle accounts with 35,000, or 50 percent, of their corporate tax cases; 52,000 or 45 percent of small business; and 380,000 or 40 percent of individual taxpayers. These amounted to \$1.14 billion in arrears revenue. The vicious cycle set the tax authorities back a few months each year in terms of their assessment efforts. One telephone survey rated the tax administration agency in Singapore among the lowest in terms of public satisfaction. That was clearly unacceptable in a government that was obsessed with efficiency and competitiveness (World Bank Group, 2000).

So, IRAS embarked on an enterprise-wide organisational transformation to re-examine its operations. The re-engineering efforts in IRAS began to refurbish the traditional tax-type organisation into process structures, eliminating highly compartmentalisation and divide-and-rule management systems across tax types. Embedded in the heart of the re-engineering was a \$69 million Inland Revenue Integrated System (IRIS) - an elaborate computer program that allowed the handling of all tax types to be dealt with in an integrated one-stop service manner. All transactions were fed through IRIS. On average, about 80 percent of the tax transactions passed through the processing pipeline without any human intervention. The remaining 20 percent that required special attention were routed to specific tax officers according to the required skill levels. The new efficiency provided by the document imaging system also contrasted sharply with the previous system where the "avalanche of papers" required "an army of office attendants" simply to move files. The application of various technologies - workflow management, and intelligent character recognition made IRAS one of the world's most technologically advanced tax administrators (Siew & Boon, 1998:496-514).

A few examples of the operational improvements IRIS brought about are addressed in the following sections.

3.2.4.1. Managing peoples' issues in the re-engineering journey

Various process design and project management issues surfaced during the transition. However, they were far less complicated and painful than the daunting people issues IRAS had to deal with. IRAS coped with essential and yet delicate people issues by building an information system for change, smoothing the change process, tackling the old entrenched culture and clarifying organisational vision (IMF, 1996).

3.2.4.2. Inculcating new systems of accountability, motivation and performance management

The management processes brought a flattened hierarchical structure with an expanded span of control. While a supervisor had previously been in charge of 5-7 officers, after the reform span of control expanded to 15-20 officers. The shift was towards inculcating individual accountability with clear performance targets. The consistent message from management was that everyone had a role to play in organisational performance. Extensive mechanisms that had enabled building individual accountability from the Commissioner right down to the support officers were therefore put in practice. One interesting accountability mechanism was the annual planning workshops, i.e. two to three day events where directors of the respective branches could present their plans and establish targets for the coming year to the entire IRAS staff. The planning workshops played a role as a means of giving the employees a sense of the overall direction of the organisation (Siew & Boon, 1998:496-514).

In addition, clear organisational performance indicators were established, e.g. tax processing efficiency, debt management efficiency and effectiveness, and quality of taxpayer services. These performance measures were then cascaded downward and the specific expectation was communicated to individual officers down to the work level through the annual performance review at the beginning of each year. In the Return Review Branch, for example, specific quantitative goals were established for tax officers, e.g. assigned cases per week per officer. The embedded workflow management system in IRAS enabled the immediate gathering of information such as number of cases allotted, open, closed and ageing information, which had not been possible before. IRAS also started automatically to capture and compile performance statistics by individual and in aggregate (IMF, 1996).

As inducement for individual accountability, IRAS revamped the reward system so that good performers could be compensated adequately. Performance evaluations were taken seriously, with individual employees being ranked within divisions and across divisions. Constructive suggestions, idea contributions and research projects were all taken into consideration. In

addition, pay increments and promotion were no longer on fixed scales but on a salary range which allows differential increments. (World Bank Group, 2000).

The experience of Singapore in reforming shows that properly managing people's issues and introducing systems of accountability and performance management are vital initiatives in creating an effective and efficient tax administration.

3.3. THE ROLE OF TECHNOLOGY AND INFORMATION MANAGEMENT IN IMPROVING TAX ADMINISTRATION

Technology can be both a facilitator and a driver of change. The use of technology in tax reform implementation has given many tax authorities new momentum in this area. It is particularly helpful in the case of meeting the responsibility for supporting and educating business and professional communities. Technology can also help to improve differentiation in treatment of taxpayers according to their individual circumstances - a form of mass customisation. In addition, a Management Information System (MIS) collects analyses and presents business data in a manner that helps decision-makers to monitor their business process (Carmody, 2000).

In the next sections the role of technology and information management and their effect on tax administration will be discussed by referring to the experiences of Spain and Singapore.

3.3.1. The Spanish experience

According to Moya and Santiago (1992:211), it would have been impossible to manage effectively the tax system of Spain, with 10 million income tax returns to process without the introduction of electronic data processing (EDP) in the 1980s. The EDP was the pillar on which the Spanish tax administration based its strategy to offer taxpayers the best possible service.

The Spanish tax administration opted for a single data processing organisation in the form of a separate Directorate General within the Secretariat of Finance. That option led to a certain amount of competition between the user directorates and the EDP directorate. That tended to keep systems operating smoothly because some officials developed the systems while others used them and that helped people not to conceal errors. But it required considerable cooperation between the users and the teams that had developed the technology.

In order to fulfil the commitments that were undertaken in terms of the *eEurope 2002 Action Plan*, Spain has launched the **INFO XXI Action Plan**: "*The Information Society for Everybody*", which covered the period of 2001 to 2003. The plan in question consists of a group of initiatives that provide an important impetus for the development of the information society in Spain. The plan includes regulatory measures as well as activities and projects with objectives,

time periods, persons in charge, collaborators and financing. Therefore, as an example of the growing use of electronic services, about 115000 and 490000 Spanish citizens submitted their personal tax returns via the Internet in the years 1999 and 2000 respectively (The Round Table Report, 2001).

When citizens were allowed to communicate with the tax administration online through the Internet, it was necessary to identify the party that could make the transaction to avoid repudiation or supplanting of personality. Electronic signatures were used to solve these questions of integrity of transaction and to avoid third party acquisition of knowledge of the contents. In addition, to guaranteeing the security of transactions two important conclusions were made by the Spanish tax authorities (The Round Table Report, 2001). The conclusions were:

- Encoding the information by the sender who decided what type of encoding he/she wanted to use, through his/her navigator.
- Decoding the information by the computer and this was performed by the Internet applications server in the tax administration office.

The Spanish experience has depicted that the introduction of EDP in tax administration enabled tax authorities to process huge amounts of income tax returns effectively.

3.3.2. The Singaporean experience

A variety of communication channels were established as a means of building an information system for change in Singapore. For example, system owners meetings, staff committees and briefing sessions with divisional/branch heads were introduced. Simultaneously, help desks, suggestion box, questions and answers, and dialogue were established to gather employee feedback and to address employees' concerns in a transparent manner. The barriers to communication were reduced as a result (World Bank Group, 2000).

The rapid capturing of ground level information or feedback was further complemented with a more intensified coordination among management. The previous divide and rule management structure has given way to integrative Commissioner's Meetings (CMs). CMs were weekly sessions in which all divisional heads were brought together to identify problems, challenge ideas, and thrash out issues. The role of CMs is to coordinate across divisions, to manage overlapping areas, and to ensure that all divisions pull in the same direction, in other words to achieve synergy. In order to encourage interaction among the management and the tax specialists, the concept of a lunch club has also been initiated. This informal atmosphere has encouraged a greater number of managers and specialists to mingle and interchange ideas. This

information system for change has enabled quick identification and resolution of issues before they grow out of control (Siew & Boon, 1998:496-514).

One of the first changes implemented by IRAS was to convert from a hard copy filing system to a paperless imaging system, which permitted documents to be retrieved instantly from networked terminals. This has improved the efficiency of the administrative process, facilitated "back end" auditing, and freed staff time from unproductive paper shuffling.

In 1995, electronic filing by telephone was introduced for individuals. Then in 1998, Singapore introduced direct electronic filing for individual taxpayers with employment income. E-filing was then extended to individual taxpayers with business income. Filers checked the entire tax form before it was submitted. If a taxpayer wanted to supply IRAS with filing information directly, all the taxpayer needed to do was to click the appropriate box to submit the form. But efforts were made to keep the system secure. For example, a personal identification number (PIN) was mailed to each taxpayer, and only raw data was accepted by the system thus preventing virus contagion. An improved process of data mining was also utilized to identify cases for audit and investigation (World Bank Group, 2000).

Later on, taxpayers could also use electronic fund transfers to pay their taxes via automatic deductions from their accounts. So adjustments in tax liabilities led to automatic adjustments in payments. Alternatively, taxpayers could pay in a lump sum using the phone, Internet banking services or, finally by debit card at payment kiosks or taxpayer service centres. Most recently, IRAS has also introduced what it calls "e-stamping" which makes it possible to pay the stamp duties levied on such documents as mortgages and stock transfers automatically. So in 1998, up to 80% of tax assessments in Singapore were made automatically and the time needed to issue assessments fell from 12-18 months to 3-5 months (World Bank Group, 2000).

In addition, staff turnover was reduced, tax arrears have fallen, property valuations kept current, and the audit function was strengthened. Public satisfaction with the tax service improved markedly.

With these advancements in tax administration, the Singapore's e-citizen centre was quoted as the most developed example of integrated service delivery in the world (Siew & Boon, 1998:496-514).

3.4. SUMMARY AND CONCLUSION

Bolivia, Jamaica, Singapore, Guatemala, Spain and Croatia have rich tax administration reform experiences that could be replicated by other countries in improving tax administration. In the case of Bolivia, the tax administration elements on which reform efforts focused were filing of

returns, payment of taxes, audit and appeal systems, control of large taxpayers, legislation reform, training, data processing, a unified taxpayer register, taxpayer relations, simplification of forms and relative operational autonomy. These reform efforts were successful in both countries due to strong international support, timely government responses to provide resources, speedy tax legislation amendments and strategies employed against resistance to change. In addition the team of like-minded specialists and the absence of interference from governments or international agencies were other success factors. As a result of the reform, Bolivian revenue rose from 1 percent of GDP in 1985 to 7.4 percent of GDP in 1990.

At the beginning of 1980s, the tax administration of Jamaica and Guatemala also had shortages of skilled staff, inadequate tax assessment and collection methods, no unique numbering system, no up-to date master filing and no annual statistical reporting and revenue forecasting models. To address these issues the government of Jamaica with the help of international organisations implemented a major reform of tax administration in 1986–1987. The revenue services were completely reorganised to integrate assessment and collection and extensive training programmes were introduced to enhance the capabilities and morale of the employees. But tax administration in Guatemala was done in *ad hoc* manner and with insignificant aid from international expertise and as a result it did not achieve the intended objectives.

The Croatian tax administration reform focused on taxpayer-centeredness, employee specialisation, and independence and the privatisation of certain activities. In order to support these objectives, the Croatian tax administration started special tax studies at Zagreb Faculty of Law in 1990s. There was also an initiative to retain a certain percentage of tax to create financial independence of the tax administration and privatisation of activities such as publishing and sending out tax forms and reports, and communication with taxpayers. Measures were also put in place to motivate employees, fight corruption and reduce tax evasion. Special services were set-up to help in achieving better public relations, increase trust in the tax system, reduce compliance costs and make the whole procedure simpler.

Singapore transformed its tax administration to improve tax compliance and in return reduce the incidence of tax arrears. Singapore embarked on an enterprise wide organisational transformation to change the classical hierarchical bureaucracy to a flat and collaborative organisation. People were given a unique glance into the complexity of managing large-scale change. The delicate people's issues were dealt with by building an information system for change, smoothing the change process, tackling the old entrenched culture, clarifying organisational vision and inculcating a system of accountability and discipline.

The role of technology and information management is well illustrated following the experience of Spain and Singapore. The use of information technology in Spain has proved its important role in tax administration. The introduction of EDP helped the Spanish tax administration to process millions of tax returns in a shorter period. The launching of the “*information society for everybody*” in Spain enabled Spanish taxpayers to submit their taxes through electronic services.

Singapore managed to convert its hard copy filing system to a paperless imaging system. So Singapore’s e-citizen service was quoted as a well-developed integrated service delivery system.

It can be deduced that a well-planned approach, the commitment and political will of government and the support of international organisations are significant factors for the success of any reform initiatives.

The present tax administration situation in Eritrea will be analysed in the following chapter. The discussion will be based on these international tax administration issues and the experiences of the above-mentioned countries.

CHAPTER FOUR

4. AN OVERVIEW OF PRESENT TAX ADMINISTRATION IN ERITREA

4.1. INTRODUCTION

Tax administration is one of the crucial factors to the Eritrean government in mobilizing the financial resources it needs at this stage of its economic history to ensure the fulfilment of the objects of the Constitution. This is clearly entrenched in Article 8 of the Eritrean Constitution (1997). The article reads, *“The state shall strive to create opportunity to ensure the fulfilment of citizens’ rights to social justice and economic development and fulfil their mental and spiritual needs.”*

In pursuance of the theoretical aspects of taxation and international tax administration issues in Chapters Two and Three respectively, this chapter will present the actual situation of tax administration in Eritrea. It therefore will outline the mission, objectives, and human resource circumstances, the application of modern technology in the IRD and the IRD’s weaknesses and strengths in dealing with taxpayers. It will also deal with the measures that have been taken by the IRD to motivate its employees and to enhance voluntary compliance on the part of taxpayers.

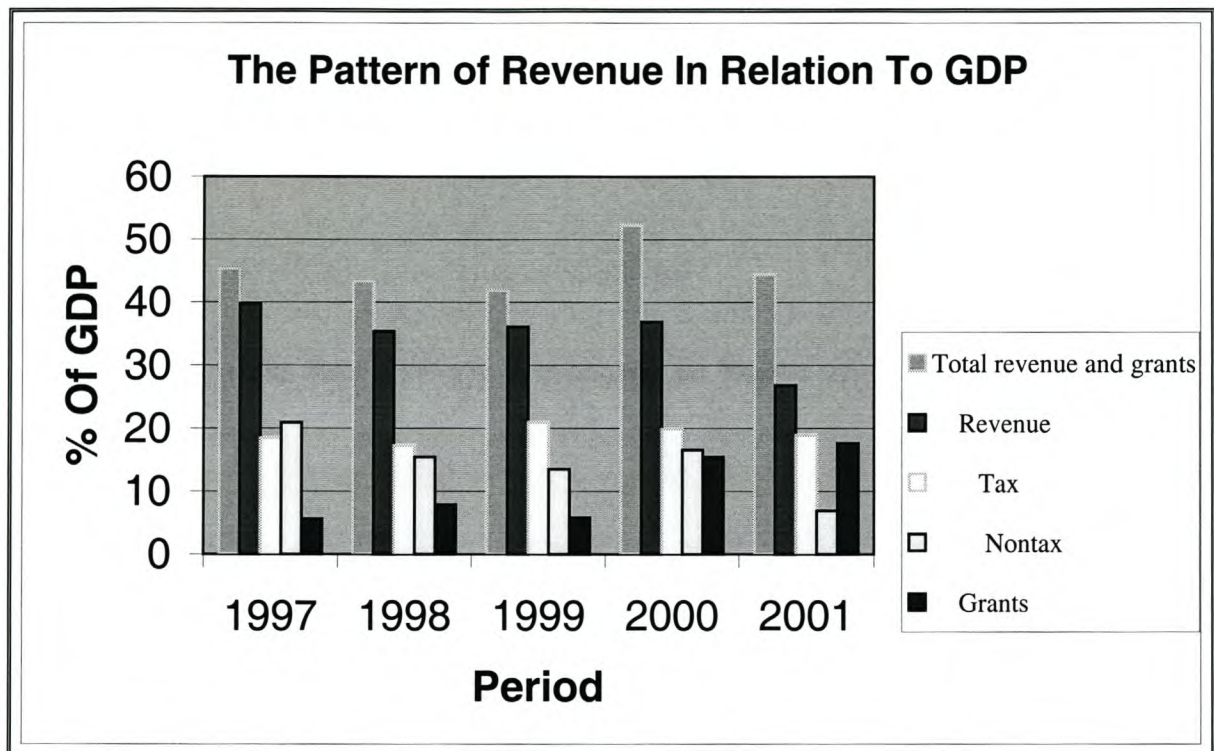
4.2. THE LATEST INLAND REVENUE DEVELOPMENTS IN ERITREA

According to Sen & Bala (2002:464-477), taxes to GDP ratio or the ratio of revenue to GDP are used to indicate the ability of a country to tap resources from a growing economy. Deficit or surplus to GDP ratios are also indicators of public financial performance.

In addition to what has already been mentioned in Section 1.2, the fiscal deficit (including grants) increased from 6 percent of GDP in 1997 to 59 percent in 1999². As shown in Annexure A, the total revenue fell from 43.3 percent of GDP to 37.8 percent over the same period and there was also a slight decrease in the collection of tax revenue. Non-tax receipts also fell by 14 percent of GDP (Brondolo, Louis and Bosch, 2001:6). Figures 3 and 4 and Annexures A and B also show that government expenditures were higher than total revenue in the years between 1997 and 2001.

² The years of border conflict between Eritrea and Ethiopia.

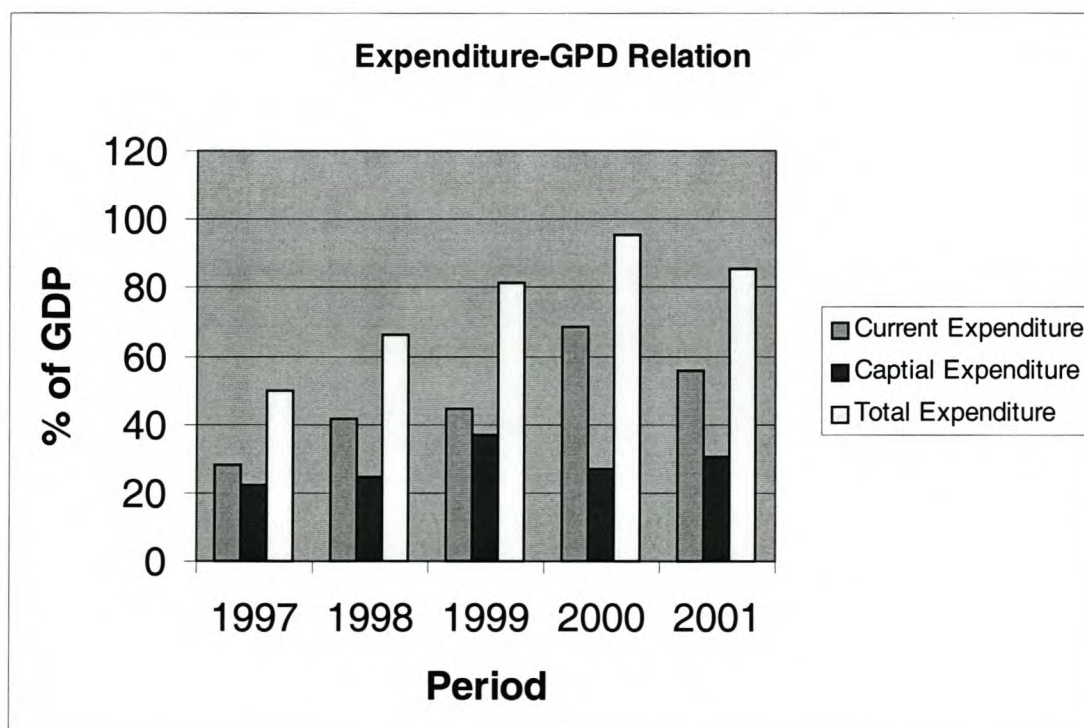
Figure 3: Revenue in Eritrea in the years 1997-2001



Source: Ministry of Finance- Eritrea

NB. The graphs in Figure 3 are arranged in a manner starting from total revenue and grants, revenue, tax, nontax and grants as shown in the legend for each year.

Figure 4: Government expenditure in the years 1997-2001



Source: Ministry of Finance -Eritrea

4.3. THE EXISTING SITUATION OF THE IRD

The IRD is a branch of the Ministry of Finance (MOF) with the responsibility for administering the domestic tax system. This system comprises several direct and indirect taxes. According to Proclamation No. 116/2001, the IRD is responsible for collecting taxes from all persons with income. Direct taxes are levied on income from wages, salaries, rent of movable and immovable properties, rural agricultural land and animals and income from trade and professional activities. In addition there are indirect taxes that include sales and excise taxes on goods and services produced in Eritrea. These taxes are collected at source from the producer. But they are not imposed on the retail level. The tax rates for sales and excise are the same for imported³ and locally made goods and services rendered. A stamp tax is also collected by the IRD. There are also other additional taxes that are imposed occasionally for different purposes. For example, there was the rehabilitation tax between 1991 and 1994 and the surtax in the years between 1998 and 2000 to finance military expenditure. In 1999, the IRD collected ERN 885 million accounting for about 40 percent of total government revenue (Brondolo *et al.*2001: 12).

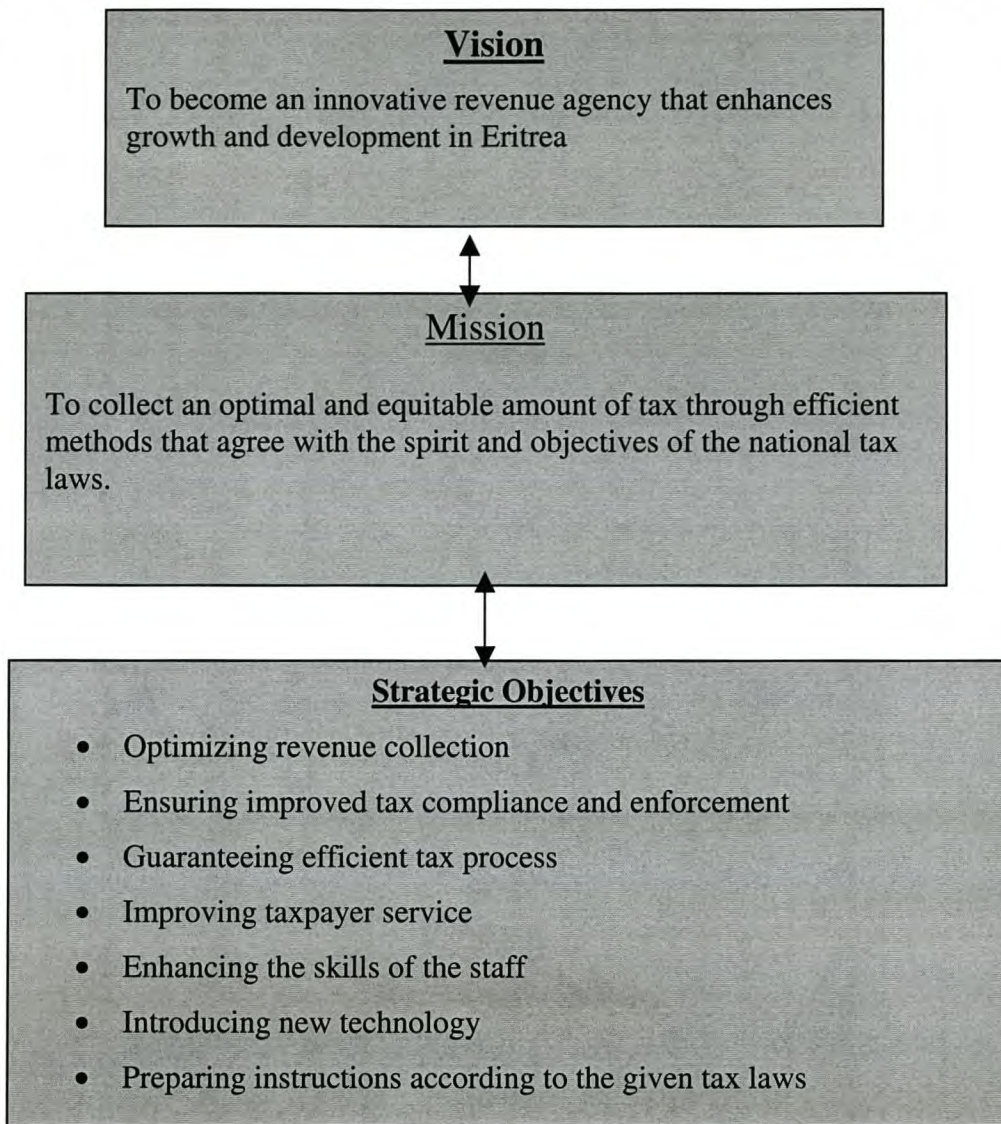
In the following sections, there will follow an explanation of the IRD's vision, mission, strategic objectives and some contemporary challenges facing the IRD and the measures taken to address them.

4.3.1. The vision, mission and objectives of the IRD

The IRD has a clear vision, mission and objectives to enhance public finance and to help in achieving the goals of macroeconomic stability and economic development in Eritrea (MOF, 1994). A schematic representation of the IRD's vision mission and objectives is shown in Figure 5 and Annexure C depicts the organisational chart of the IRD.

³ Taxes on imported goods are administered by the Customs Department

Figure 5: Schematic representation of the vision, mission and strategic objectives of IRD



4.3.2. Some of the main challenges facing the IRD

Tax administration in Eritrea has many positives developed during the armed struggle era (1961-1991). There is a culture of hard work and commitment among tax officers. Most taxpayers also show inclination to comply with their obligations according to the tax laws. In spite of these positive features, the IRD suffers from some serious weaknesses (Brondolo *et al.*, 2001:13).

According to Brondolo *et al.* (2001:13), the main current weaknesses are the absence of indicators of efficiency and effectiveness, outdated procedures, excessive paperwork, poor reporting and information management systems, the non-existence of a taxpayer education programme, inappropriate working conditions, inadequate transportation facilities, the lack of

continuous employee training programmes, unsatisfactory payment systems and the misconception of the people about the financial capacity of government.

Certain of these issues are discussed in detail in the following sections.

4.3.2.1. Indicators of effectiveness and efficiency

Although Article 11 of the Eritrean Constitution (1997) calls for the civil service to have effective, efficient and accountable administrative institutions, there are no indicators of effectiveness and efficiency. The IRD does not have a clear system of performance measurement. The performance of the tax administration can only be inferred on the basis of indirect indicators such as the cost of collection ratio⁴ and the number of the taxpayers per tax officer. The other check for performance is to measure the number of hours being spent in offices by tax officers. There are no realisable measures of the overall effectiveness of the tax administration such as the extent of tax evasion and the amount of arrears in a given period. But the compliance level among the taxpayers is generally thought to be low as evidenced by the poor record keeping practiced by some businesses (Brondolo *et al.*, 2001:13).

4.3.2.2. Administrative procedures

There are outdated and control-oriented administrative procedures which were inherited from the pre-independence period (prior to 1991). These procedures rely on massive information reporting, excessive paperwork, the issuance of tax assessments by tax officials (except for category A in which self-assessment is introduced) and universal examination during auditing. Under the existing arrangements, taxpayers (category A& B) are generally required to submit their books of account to the tax officers for examination at the assessment. If accepted, an interim tax assessment (on account) is then calculated on the basis of these books and payment is normally made in cash at the tax office for tax amounts less than ERN⁵ 3000. But for taxes exceeding ERN 3000, taxpayers prepare a cash payment order (CPO) and pay the money in the banks. In this case the process of payment is not completed to the banks because there is no special arrangement or network between these agencies. The taxpayers are asked to go to IRD offices to get the receipts of payment. In addition, the one page declaration forms for sales, profit and personal income are self-guiding but they do not allow recording both tax returns and payments at the same time.

⁴ The cost of collection ratio is defined as the total expenditure divided by total revenue collected

⁵ The Eritrean currency is known as Nakfa (US\$ 1 is equivalent to ERN 14)

The valuation of all items is done by physical inspection. All taxpayers are in principle subjected to a comprehensive audit of all liabilities at least once in seven years. Selective risk-based audit programmes have not yet in operation (Tirhas, 2002).

The appeal system is familiar to few people and most of the time the appeal procedures are time consuming.

4.3.2.3. Computer system

The department is short of a modernised computer system in most functions except for the cash payment division and in the newly formed Large Taxpayer Office (LTO) in the capital city. Even computers which are available in headquarter are not sufficiently up to date to assist in tax processing. A manual system remains the principal source of information (Said, 2002).

4.3.2.4. Means of communication and information in educating taxpayers

It seems that the IRD has paid little attention to taxpayer education though it is the most basic service, which can improve tax processing procedures. There are no clear measures taken to introduce a taxpayer education programme that includes designing tax returns and clear instructions, and making them available free of charge at conventional locations (Said, 2002).

In general the educational curriculum in Eritrea does not include any courses or subjects related to taxation. The IRD has no especial and regular programmes on radio or television for educating taxpayers to help them understand their duties and rights. There are occasional notices that are broadcast on the public television, on radio and in newspapers towards the end of the tax year⁶ to remind people of the period of filing and payment of taxes. The IRD does not have its own newsletter or pamphlet as means of communication with the public.

Communication and information management systems in Eritrea are not well advanced. They are in their early stages of development. The present telephone system in the IRD is outdated. Most divisions of this department have no direct link with taxpayers. The existing telephone link is through a central operator switchboard, which is engaged most of the time (Said, 2002).

⁶ The tax year in Eritrea runs from 1st January to 31st December

4.3.2.5. Working environment and means of transportation

The physical infrastructure of the IRD is in a very poor state (2002). There is a problem of personnel shortage in all regions. Some regional tax offices are too small to effectively administer the taxpayers in their jurisdictions. At the same time the quality of the present premises is not conducive to proper operations. Some offices suffer from overcrowding, poor office layout, and inadequate electronic and telecommunication systems (Said, 2002).

As a means of control, all governmental vehicles in Eritrea are at present administered from one centralised office to which all departments must apply to get vehicles to conduct their daily activities. IRD thus does not have its own means of transportation.

4.3.2.6. Human resource conditions in the IRD

According to Brondolo *et al.* (2001:12), in order to carry out its revenue collection responsibilities, the IRD had an authorised staff of 538 officials who were deployed in all regions of Eritrea in 2001. But there were about 219 vacant positions due to the war (1998-2000) and due to the difficulties in recruiting qualified staff. Some of those positions were later filled by people performing national service⁷. According to Section 25 of the Eritrean Constitution, it is a constitutional duty for every citizen to complete national service. But the recruitment of these national service members is not done in accordance to normal procedures and screening requirements for IRD personnel.

In addition, the modernisations of the IRD's operations involve the introduction of broad administrative procedures and computer systems. Tax officers will require intensive training to be able to carry out these procedures efficiently. However, the IRD does not have formal training programmes for managers and other tax officers. There are no training curricula and materials. But there are some intermittent training sessions that are given from time to time on an on-the-job basis. In addition, as an initiative to improve the competence of its people, MOF has recently sent some of its employees abroad for further studies and they are expected to fill the gaps in the ministry in the near future (Said, 2002).

Since the IRD is a department in MOF, its employees are paid at the same scale as other civil servants in Eritrea. Although the IRD is the main body responsible for collecting tax, it is not allowed to keep an amount of the tax collected. All taxes collected are directly transferred to the Treasury Department in MOF. The present compensation packages for all employees are extremely low. Employees do not get a living wage. The problem of low salaries is further

⁷ Every citizen between the ages of 18 and 40 is obliged by law to serve in the military for 18 months

exacerbated by limited availability of accommodation and other facilities for the officials. So, public servants are presently not satisfied with their salary conditions. This is further exacerbated by high inflation, which has come about as a result of border conflict. Prices of necessary commodities have at least doubled in the years since 1998 but there has been no adjustment in the salaries. For instance, the monthly gross salary of a public servant with a BA degree has been ERN 1500 since 1996. The exchange rate at the outset of the war was ERN 7.2/US \$ 1, but in 2002 declined to ERN 14/US\$. This has an impact on the most essential commodities because most of them are imported. The discontent with salaries is even worse among the national service employees who are paid less than permanent workers. Relatively speaking, the salaries in the private sector are better than those in the public sector at this time. Although they are not indexed properly, remunerations in the private sector match the escalating prices in Eritrea (Teclezghi, 2002: IRD Administration, 2002).

4.4. THE TYPES OF TAXES ADMINISTERED BY THE IRD

The IRD is responsible for administering personal (employment taxes), rental taxes, profit taxes, sales and excise taxes, agricultural taxes and stamp duties as addressed in Section 4.3 (IRD Administration, 2002).

4.4.1. Personal tax or employment tax

According to Proclamation No.116/2001, rates and brackets have been reduced for employment tax in contrast to the previous proclamation No.62/1994 as shown in Tables 2 and 3. The rates are progressive up to 30 % after which they remain proportional. These taxes are withheld by employers on salaries, allowances, contributions and other personal emoluments. The employer assumes the responsibility for deducting the correct amount of tax from each employee at the end of each payment period (mostly at the end of a month) and deposits it in the account of the IRD in a bank or pays it to the IRD office (Eritrea, 2001).

Individuals working in embassies and non-governmental organisations (NGOs) are also required to declare their income and pay tax in the nearest tax office. In this case, there is no proper control mechanism that forces or motivates such individuals to fulfil their obligation. Most of the time such people are forced to pay taxes when there is a disagreement between the employer and employee that results in a court case.

But incomes from the employment of unskilled workers on a daily and irregular basis are exempted from this tax (Eritrea, 1999).

Table 2: The old Income tax rates on employment (62/1994)

| Annual taxable income (in ERN) | Marginal tax rate |
|---------------------------------------|--------------------------|
| Up to 200 | 2 |
| 201 - 500 | 7 |
| 501 - 1200 | 12 |
| 1201 - 2000 | 17 |
| 2001-3500 | 24 |
| 3501-5500 | 29 |
| 5501-8000 | 34 |
| Over 8000 | 38 |

Table 3: The new income tax rates on employment (116/2001)

| Annual taxable income (In ERN) | Marginal tax rate | Shorter formula to work out the amount of tax |
|---------------------------------------|--------------------------|--|
| Up to 200 | 2 | Salary x 2% |
| 201 - 1200 | 10 | (Salary x 10 %)- 16 |
| 1201 - 2500 | 20 | (Salary x 20 %)- 136 |
| 2501 - 3500 | 25 | (Salary x 25 %)- 261 |
| Above 3500 | 30 | (Salary x 30 %)- 436 |

4.4.2. Income tax derived from movable and immovable property

This annual tax is levied on all income received in cash and in kind for the rental of movable and immovable properties. It is assessed based on returns filed by the taxpayer at the end of each year. These payments are required to be made within one month after the end of the tax year. But there is a deduction of 25 percent of gross income as allowance for repairs, maintenance, and depreciation, so the taxable income is 75 percent of the income received. Tables 4 and 5 compare the new and old rates of rental tax. Table 4 depicts the old rates ranging from 1.5 to 48 percent. For people with an income below ERN 120, the tax amounted to ERN 1 per annum (Eritrea, 1995).

Table 4: The old rental income tax (62/1994)

| | Annual taxable income from rent(ERN) | Marginal tax rate |
|----|---|--------------------------|
| 1 | 121 -380 ⁸ | 1.5 |
| 2 | 381-480 | 3 |
| 3 | 481-660 | 4.5 |
| 4 | 661-840 | 6 |
| 5 | 841-1020 | 8 |
| 6 | 1021-1200 | 10 |
| 7 | 1201-1600 | 12 |
| 8 | 1601-2000 | 14 |
| 9 | 2001-2400 | 16 |
| 10 | 2401-2800 | 18 |
| 11 | 2801-3600 | 20 |
| 12 | 3601-4400 | 22 |
| 13 | 4401-5200 | 24 |
| 14 | 5201-6000 | 26 |
| 15 | 6001-8000 | 28 |
| 16 | 8001-10000 | 30 |
| 17 | 10001-12000 | 32 |
| 18 | 12001-16000 | 34 |
| 19 | 16001-20000 | 36 |
| 20 | 20000-24000 | 38 |
| 21 | 24001-30000 | 40 |
| 22 | 30001-36000 | 42 |
| 23 | 36001-42000 | 44 |
| 24 | Above 42000 | 48 |

⁸ Up to ERN 120 the tax charged was ERN 1

Table 5: The new rental income tax (116/2001)

| Annual taxable income from rent(ERN) | Marginal tax rate | Shorter formula to work out the amount of tax |
|---|--------------------------|--|
| Up to 2400 | 2 | rental income x 2% |
| 2401 -14400 | 10 | (rental income x 10 %)- 192 |
| 14401 - 30000 | 20 | (rental income x 20 %)- 1632 |
| 30001 - 42000 | 25 | (rental income x 25 %)-3132 |
| Above 42000 | 30 | (rental income x 30 %)- 5232 |

4.4.3. Taxes on income from trade, business and professional activities

This annual tax is levied on individuals or companies that are engaged in commercial or professional activities. This type of tax is the main source of revenue in Eritrea. The tax rates and brackets for companies without limited liabilities (unincorporated bodies) are shown in table 6 and 7. According to the new Proclamation No.116/2001, companies with limited liabilities (incorporated bodies) are not included in this schedule because they are required to pay a fixed rate of 30 percent of their annual income. Before this amendment, these rates ranged between 25 and 35 percent (Eritrea, 1999).

In addition, lottery and tombola winners with prizes over ERN 500 and bingo winners with proceeds of more than ERN 400 are required to pay 10 percent of their income. Royalties and services rendered from abroad are also taxed at 10 percent (IRD Administration, 2002).

Income from dividends and personal interest and income from self-employed persons residing in rural areas are exempted from this tax. In addition, the new proclamation allows any net loss incurred in one year to be set off against taxable business income in the next five years (Eritrea, 1999; Eritrea, 2001).

Table 6: Trade, business and professional income tax (62/1994)

| Annual taxable income from commercial | Marginal tax rate |
|---------------------------------------|-------------------|
| Up to 2000 | 2 |
| 2001 –5000 | 7 |
| 5,001 – 18000 | 15 |
| 18001 – 35000 | 20 |
| 35001-60000 | 25 |
| 60001-100000 | 30 |
| 100001-150000 | 35 |
| Above 150000 | 38 |

Table 7: Trades, business and professional income tax (116/2001)

| Annual taxable income from commercial | Marginal tax rate | Shorter formula to work out the amount of tax |
|---------------------------------------|-------------------|---|
| Up to 2400 | 2 | trade income x 2% |
| 2401 -14400 | 10 | trade income x 10 %)- 192 |
| 14401 - 30000 | 20 | (trade income x 20 %)- 1632 |
| 30001 - 42000 | 25 | (trade income x 25 %)-3132 |
| Above 42000 | 30 | (trade income x 30 %)- 5232 |

4.4.4. Income tax on agriculture

For the purpose of taxation, agriculture is categorized as commercial or traditional. Commercial farming is limited. As already stated in Section 1.2, 80 percent of the Eritrean people depend on traditional subsistence farming. The amendment of 2001 has not affected the tax rates in this sector so there will be no comparison of the proclamations.

4.4.4.1 Income tax on commercial agriculture

Individuals or companies involved in modern commercial activities are liable to pay a certain portion of their annual income as tax as shown in Table 8. These taxes are assessed on the basis of the returns filed by the farmers and the taxes are payable annually (IRD Administration, 2002).

Table 8: Income tax on commercial farming (116/2001)

| Annual taxable income from commercial | Marginal tax rate | Shorter formula to work out the amount of tax |
|---------------------------------------|-------------------|---|
| Up to 1000 | 2 | income x 2% |
| 1001-10,000 | 5 | (income x 5 %)- 30 |
| 10,001-20,000 | 10 | (income x 10 %)- 530 |
| 20,001-35,000 | 15 | (income x 15 %)-1,530 |
| Above 35,000 | 20 | (income x 20 %)- 3,280 |

4.4.4.2 Income tax on rural land use and small scale animal farming

People who practice traditional farming and animal husbandry are taxed differently to the modern commercial farmers. In this case the amount of tax is ERN 18 per farm per year. But if people are involved in minor commercial farming without having a commercial farming license, an extra ERN 20 per year is paid for every hectare of land used. The tax assessment and collection is done annually by local committees who in turn submit the collected tax to the representatives of the IRD in their respective sub-region or region (Eritrea, 1995; Eritrea, 1999). Table 9 depicts the tax rates for animals.

Table 9: Specific tax rates for each head of livestock (116/2001)

| Kind of Animal | Amount of tax per head per year (ERN) |
|-----------------------|---------------------------------------|
| Camel | 4.00 |
| Cattle, horse or mule | 2.00 |
| Donkey | 1.00 |
| Sheep or goat | 0.50 |

4.4.5. Sales and excise taxes

Unlike other countries such as South Africa which use VAT, the only indirect taxes that are administered by the IRD are sales and excise taxes on goods produced and services rendered.

4.4.5.1. Sales tax

This tax is levied on wholesalers, service providers and manufacturers who must declare their sales or production. They are required to submit a list of the names of the purchasers with their full details monthly. According to Proclamation No.117/2001 that amended Proclamation No.64/1994, the sales tax rates are 5, 10 and 12 percent for domestic or imported goods and services. Before the amendment the rates were 3, 5 and 12 percent. It is the responsibility of the producer to collect and bring the tax to IRD offices within the month subsequent to production. The tax base for services rendered locally is the value of the service, and the collection of the tax is the responsibility of the service provider (Eritrea, 2001; Eritrea, 1999).

There are 33 groups of goods and 12 types of services, which are completely exempted from this tax as shown in Figure 6. In addition, sales taxes paid for raw materials used for local production are refunded by the IRD to manufacturers (Eritrea, 2001).

Figure 6: Some of the goods and services exempted from sales taxes in Eritrea

Exempted Goods

- Beasts of burden & food
Cereals, Legumes & bread
- Aviation fuel, kerosene & furnace oil
 - Conveyor, transmission devices
 - Wooden hives & incubators
 - Electricity producing engines
 - General industrial machinery equipment
 - Ambulance, fire-engine, refuse & road maintaining vehicles & public transport
 - Medical furniture & instruments
 - Gold, copper & silver imported by the Bank of Eritrea
 - Movie cameras & projectors
 - Trains, aircraft, ships and their parts

Exempted Services

- Water supply & ice production
- Electricity services
- Entertainment admission tickets which are subject to Stamp Duty
- Sales of locally made cars, businesses & houses
- Kindergarten & formal education
- Transport services
- All medical services
- Solar energy services
- Weight & measure controls
- Service of foreign currency transmission, banking & insurance service
- General educational promotion
- Shoe shine service

4.4.5.2. Excise tax

This tax is levied on specific goods which are produced locally and/or imported from abroad. The IRD is responsible for administering the taxes imposed on locally produced goods. This tax is levied at factory level on all manufactured goods and it is payable within one month from the date of production. The tax base is assessed on the basis of cost of production through self-assessment. But goods produced locally for export are exempted from sales taxes.

In addition, all producers are required by law to keep a daily record of their production and this record must be submitted to IRD monthly. Producers are also required by law to allow access to the representatives of IRD to their production sites during working time for the purpose of supervising production. The main objectives of the excise tax are (MOF, 1994):

- To discourage the consumption of certain products that are harmful to the health of citizens such as wine, tobacco products and beverages with high alcoholic content;
- To protect domestic factories, such as the beer and cigarette producing factories in Eritrea; and
- To realise additional revenue.

So, the differentials in tax rates reflect the above-mentioned objectives. The rates are specific or *ad valorem*. Due to the amendment there was an increase in the rates of cigarette and other tobacco products but rate reductions for automobiles between 1994 and 2001 as shown in Table 10 and 11 (IRD Administration, 2002).

Table 10: The excise tax rates on selected goods (64/1994)

| No. | Types of goods | Excise tax rates |
|-----|--|--|
| 1 | Mineral water | 10% |
| 2 | Beer | 100% |
| 4. | Wines of any kind | 50% |
| 5. | Beverages with high alcoholic contents, like Whisky, Rum, Vodka, Brandy, Gin, Araki... etc | 50% or ERN 3.00 per litre which ever is higher |
| 6. | Cigars, cigarettes and similar products | 50 % |
| 7. | Tobacco for snuff, chewing and extracts...etc | 50 % |
| 9. | Land Rover, Land Cruiser, Jeep and the like | 90 % |

Table 11: The excise tax rates on selected goods (11/7/2001)

| No. | Types of goods | Excise tax rate |
|-----|---|--|
| 1 | Mineral water | 15% or ERN 0.2 per litre which ever is higher |
| 2 | Lemonade and flavoured spa water including beverages such as syrup, Coca –cola, Pepsi...etc | 15% or ERN 0.3 per litre which ever is higher |
| 3. | Beer a) Malted beer (bottled or canned) B) Draft beer | 100% or ERN 3.00 per litre which ever is higher 100% or ERN 2.15 per litre which ever is higher |
| 4. | Wines of any kind | 50% or ERN 2.00 per litre which ever is higher |
| 5. | Beverage with high alcoholic contents, like Whisky, Rum, Vodka, Brandi, Gin, Araki... etc | 50% or ERN 3.00 per litre which ever is higher |
| 6. | Cigar, cigarettes and similar products | 100% or ERN 100.00 per kg which ever is higher |
| 7. | Tobacco for snuff, chewing and extracts...etc | 100% or ERN 20.00 per kg which ever is higher |
| 8. | Automobiles a) Up to 1800 cc b) Over 1800 cc | 25 % 35 % |
| 9. | Land Rover, Land Cruiser, Jeep and the like | 35 % |

4.4.6. Stamp duties

Stamp duties are another source of revenue in Eritrea. They are levied on a range of legal documents and instruments that include (Eritrea, 1995):

- ❖ Documents transferring title to property through legacy, donation, will, sales or any other transactions;
- ❖ The invested shares of new members of privately owned firms;
- ❖ All kinds of forms;
- ❖ Issuance certificates; and
- ❖ Tickets of admission to places of public entertainment.

The selling of stamps is the only tax administration activity that can be carried out by private agents in Eritrea. Certain persons or firms are appointed by the IRD to buy stamps and stamped papers at a discount of 5 percent representing the remuneration for their service. But these centres of stamp sales are limited mostly to bookshops, which are few or even non-existent in some areas. These vendors of stamp duties are also required by law to display notices in their windows or other visible places in their shops to indicate the availability of stamps (Eritrea, 1995).

4.5. PAYMENT AND PENALTY PROVISIONS

Every person is required by law to pay the correct amount of tax at the proper time. If any taxpayer fails to file tax returns, or pay tax due at the right time or maintain books of accounts, he/she will face administrative penalties. The rates for penalties are (IRD Administration, 2002):

- A penalty of 20 percent of tax due for failure to submit declarations on time;
- If the taxes are not paid at the time decided by the IRD, the tax due increases by 5 percent each month up to a maximum of 50 percent; and
- Taxpayers (category A and B) who do not maintain books of account or whose books are not acceptable are penalized by 20 percent over the assessed amount of tax.

These provisions do not include any interest on late payment. The penalty system does not clearly distinguish between penalties that are fines for failure to carry out obligations under the law and the interest that is charged for the use of money. Furthermore once the 50 percent limit is reached, the taxpayer has no incentive to pay since the penalty has reached its maximum level. In addition tax penalties are not indexed to match inflation (Goorman, Firestone & Cunningham, 1994:22).

The most effective and commonly used collection enforcement tools by modern tax administration such as the authority to demand direct payment from bank accounts or to issue a lien on the physical property of a delinquent taxpayer are not used in Eritrea without court authorization (Brondolo *et al.*, 2001:25).

In addition, when taxpayers are allowed to pay tax debts in instalments, there are no clearly defined conditions. The conditions for eligibility are: (1) the filing of a financial statement by the taxpayers and its subsequent review by the tax officers to demonstrate that the taxpayers have no other viable means to pay;(2) the taxpayers have good compliance history and pledge to fulfil their obligations in future;(3) the taxpayers are financially viable;(4) interest continues to accrue on the unpaid taxes during the instalment agreement and (5) posting some form of security as a condition for instalment payment (Brondolo *et al.*,2001:25).

4.6. THE CATEGORIES OF BUSINESS TAXPAYERS IN ERITREA

According to Brondolo *et al.* (2001:13), as of October 2000 there were 53356 registered business taxpayers in Eritrea. These taxpayers are divided into three categories A, B & C, which determine the assessment and bookkeeping requirements upon them. The logic behind this categorizing is (1) to distinguish the necessity of bookkeeping and self-assessment; (2) to differentiate the period of payment; and (3) to allow the IRD administration to concentrate its attention on taxpayers that provide the bulk of revenue.

Taxpayers in category A are companies with limited liabilities or businesses with annual gross incomes exceeding ERN 350000. These taxpayers are required to self-assess their taxes and to maintain balance sheets, profit and loss statements and other essential documents to show their actual income. These documents should be provided within four months after termination of the tax year (IRD Administration, 2002).

Category B taxpayers are generally defined as taxpayers with annual gross incomes between ERN 100000 and 350000; taxpayers who are involved in professional or vocational activities and whose annual gross income is above ERN 18000; and importers and exporters with annual income of less than ERN 350 000. These taxpayers are requested to keep books of account but they are not required to self-assess their tax at this time. Taxpayers in this category must present their documents within two months at the end of the tax year (Eritrea, 1995).

Category C taxpayers are those with annual gross incomes of less than ERN 100000 and people who are involved in professional or vocational business activities with an annual gross income of less than ERN 18000. These taxpayers are not required to keep books of account and self-assess

their tax. These taxes are assessed on a presumptive basis and must be paid within one month of the end of the tax year (IRD Administration, 2002).

4.7. RECENT DEVELOPMENTS IN THE IRD

There are some recent initiatives that have been taken to improve tax administration in Eritrea. Among these changes are the formation of the Large Taxpayer Office (LTO) and the separation of the IRD headquarters which is no more involved in the direct administration of taxes.

4.7.1. The formation of LTO

As part of its re-organisational plan, the IRD established a separate office to administer all “category A” taxpayers throughout the country in June 2001. It was set-up outside of the headquarter office in Asmara (the capital) and it reports to the Director General of the IRD at the headquarter as shown in the organisational chart in Annexure C. The LTO is responsible for collecting all taxes (except those on imports) from large taxpayers. The formation of this office was supposed to address the revenue haemorrhage issue by closely monitoring those taxpayers who are the major contributors of tax revenue in Eritrea. Those taxpayers accounted for about 81 percent of business income collected in 1999 (Brondolo *et al.*, 2001:13; Tirhas, 2002).

The people assigned in this office are well qualified although many of them are engaged in national service. The logic behind assigning of such personnel is because the tax affairs of large taxpayers tend to be more complex than those of other categories. In addition, the computer system is also up-to-date and all large taxpayers are entered in this system against their identification numbers. The process of payment has become simpler in this office compared to the process in other categories. Taxpayers fill a one-page declaration form and can pay their taxes in one office. It is also possible to pay more than one type of tax in the same office at the same time because the new declaration form allows that procedure easily (Tirhas, 2002).

4.7.2. Separation of headquarter

New tax offices were opened in Asmara to take over the responsibility of administering taxes from the IRD headquarters. The IRD headquarters is since 2001 no longer directly involved in administering taxpayers. Instead it has focused its efforts on developing and monitoring national programmes and overseeing the department’s modernisation programmes.

Although it was impossible to find the exact statistics to show the actual increase, these changes have helped in increasing the national revenue in the first quarter of 2002. That has been clarified in the presentation of the Minister of Finance in the Cabinet Session of April 2002 (Minister of Finance, 2002).

4.8. SUMMARY AND CONCLUSION

Revenue level from taxes and other sources remain unsatisfactory. This is indicated by the declining revenue to GDP ratio and the increasing deficit to GDP ratio.

The IRD is a branch of MOF and it is responsible for administering the domestic tax system which is composed of personal, rental, agricultural, profit, sales and excise taxes. But the IRD suffers from some weaknesses which include the absence of indicators of efficiency and effectiveness, outdated manual procedures, excessive paper work, poor reporting and information management and the non-existence of taxpayers' education and employee training programmes.

There have also been changes in the tax proclamation. Proclamation No.62/1994 was replaced by Proclamation No.116/2001 to reduce the brackets and tax rates for employment and rental considerably. Proclamation No.64/1994 was also replaced by Proclamation No.117/2001 to reduce the rates for excise taxes and to increase the rates in sales tax for some goods and services.

Penalty rates do not exceed 50 % of the tax due and the penalty does not include interest for late payment. There are no clearly defined conditions for eligibility when taxpayers are allowed to pay their debt by instalment.

Eritrean business taxpayers are categorised into A, B and C categories to determine their assessment and tax book keeping requirements. Category A and B are required to keep books of account. At this time, Category A taxpayers are administered by the LTO.

This chapter outlines that the financial performance is not good as highlighted by the financial indicators. The present administrative procedures are dominated by outdated and control-oriented activities that are signs of inefficient and ineffective organisation

There will be an assessment of the present situation of tax administration in Eritrea with reference to theoretical and best practices in tax administration in the following chapter.

CHAPTER FIVE

5. ASSESSMENT OF THE PRESENT STATUS OF TAX ADMINISTRATION IN ERITREA

5.1. INTRODUCTION

This chapter discusses the reasons for the weaknesses of the tax administration in Eritrea and the consequences of weaknesses in tax collection. This assessment is based on the theoretical aspects dealt with in Chapter Two; examples of international tax administration as described in Chapter Three and the findings concerning tax administration that have been highlighted in Chapter Four.

There is a difference between the provisions of Proclamation No.116/2001 and Proclamation 62/1994 concerning personal (employment) income tax, rental income tax and income tax from trade, business and professional activities. Proclamation No.62/1994 and the new Proclamation No.117/2001 will be compared to determine the changes in the tax rates on sales and excise taxes and their implication on investment, consumption and saving will be considered.

5.2. REVENUE CONDITIONS IN THE YEARS 1997-2001

According to the indicators mentioned in section 4.2, Eritrean tax administration performance seemed to be inadequate in raising enough resources through taxes in the years between 1997 and 2001. The deficit was high as shown in Annexure B and the figures in Annexure A also indicate that the revenue to GDP, non-revenue to GDP and tax to GDP ratios declined. The decline in these ratios is indicative of inefficiency and ineffectiveness of tax administration as explained in Section 4.2. This is one of the indicators of weakness of Eritrean tax administration which was unable to tap resources in order to increase revenue. As indicated in Figures 3 and 4, government expenditures are high compared to revenue generated. The decrease in non-revenue taxes is due mostly to the loss of port fees associated with transshipment to and from Ethiopia. The slight decline in tax revenue was due to the introduction of surtax that was imposed during the period of war. The years between 1998 and 2000 were problematic to all taxpayers who paid double the normal taxes. The lowering of revenues and the increase in expenditures are due to the war as well as to the ineffectiveness and inefficiency of tax administration.

If this persists without any remedial measures, the government will fail to generate enough revenue to finance the costs of collective goods and services. Government may also opt for other

sources of finance such as borrowing and printing money that may harm the overall economy in the long run (Sections 2.3 and 2.4).

5.3. ADMINISTRATIVES PROCEDURES AND AUTOMATION

As highlighted in Section 4.3.2.2, the current time consuming administrative procedures in the IRD have negative impacts on both employees and taxpayers. Tax officers are spending most of their time in reviewing financial statements and issuing assessments. Tax authorities have little time left to conduct more effective investigative and educational activities. In other words, the tax authorities are unable to focus on the core functions of tax administration as mentioned in Section 2.7.1. Such administrative procedures are tiresome and less effective. In addition the absence of selective auditing does not enable the IRD to focus on taxpayers who pose the highest risk of underreporting their tax liabilities. The valuation of homogenous items through physical inspection and having different forms for returns and payment are time-wasting and costly to both the tax administration and the taxpayers as indicated in Section 4.3.2.2.

The existing procedures do not encourage taxpayers to comply with their tax obligations. Such cumbersome procedures contribute to people not paying their taxes at the proper time. In addition, if administrative procedures are not simple people may choose not to comply with them. For example, people may prefer not to appeal against incorrectly assessed taxes and simply pay the assessed amount of tax because the cost of appeal will be more than the assessed tax.

In addition, the absence of a modern computerisation systems means that the IRD does not have the capacity to generate basic background information on the overall taxpayer population. This system causes the IRD to depend on antiquated manual procedures that consume a large part of the IRD staff resources and time, and prevent them from attending to priority tasks such as detecting delinquent taxpayers and non-filers.

The introduction of a computer systems and the replacing of manual procedures by paperless imaging systems have potentially a significant impact on simplifying the above-mentioned administrative procedures as mentioned in Section 3.3.2.

Finally as mentioned in Section 4.3.2.1, the absence of performance measures will lead to high levels of ineffectiveness and the absence of accountability for results.

5.4. COMMUNICATION AND TAXPAYER EDUCATION

As pointed out in Section 4.3.2.4, the absence of in-house publications causes people not to be acquainted with the IRD's functions, vision, mission, objectives, taxation procedures and the duties and rights of the taxpayer. The absence of publications engenders lack of transparency in public finance. People do not know why and how taxes are collected. At the same time people do not have enough knowledge about public finance in order to play their roles in controlling tax officials. Therefore, as indicated in Section 2.6 the Eritrean tax system lacks tax visibility that is one of the key properties of a good tax system.

As mentioned in Section 4.3.2.4, the notices that are made public during the payment period can pass without being observed by most people. At the same time such notices give inadequate information and do not inspire taxpayers to fulfil their obligations.

As indicated in Section 4.3.2.4, the poor communication systems in the IRD is another factor that leads to prolonging tax processing. Taxpayers are unable to get accurate information about their tax status from their work places or homes. At the same time, the ineffective telephone system leads to poor information interchange among the different offices in the IRD. It is common to see tax officers with files at hand running from office to office during the busy tax payment period. As a result tax officers cannot process a sufficient volume of tax data.

The absence of continuous and proper taxpayer education is one of the causes of misconception that people harbour about the financial capacity of the government. There is a misconception that the government is endowed with unlimited financial resources. This perception is even common among most educated people. But it is worse among the rural people who pay taxes only so as not to be penalized. So, it is a common phenomenon to see people complaining about taxes without any justification. This is mostly the result of ignorance due to the absence of well-designed and continuous taxpayer education (Section 4.3.2.4). Most people are unaware that taxes are the main sources of finance to cover all costs of services provided by the government. From the experience of Croatia as outlined in Section 3.2.3, the introduction of tax courses in the Eritrean educational curriculum will help to raise the consciousness of the people towards taxes.

Although paying taxes is painful as stated in Sections 1.1 and 2.9.1 complaints can be minimised if taxpayers are given adequate information, education and assistance to know their obligation.

5.5. HUMAN RESOURCE AND FACILITIES CONDITIONS

Section 2.9.2.2 argues that the management of human resources is the pillar of all organisations. But as has been cited in Section 4.3.2.6, at this time the recruitment policy of the public sector in general and the IRD in particular is not suitable for attracting the very best employees from all

professions that are needed in the tax administration service. Although devotion, commitment and sacrifice are common phenomena among workers in the IRD, this cannot last forever. As has been indicated in Section 2.8.1, lower salaries and having no other incentives for long periods may ultimately lead to corruption or employees abandoning the organisation to work for private enterprises. Relatively speaking, the problem of corruption is not too serious in Eritrea. Eritrea is known in the Horn of Africa for having non-corrupt public servants. But one cannot ignore corruption, especially after the recent war. As the Eritrean local proverb goes, “*leather must be treated while fresh.*” Corruption may indeed be difficult to eradicate once it becomes widespread and entrenched. If crucial anti-corruption measures are not taken now, it will be difficult to reverse when corruption is deep-rooted in this department. Unlike other departments that do not deal with money, the IRD is a more sensitive area that needs more careful attention. It is true that people with insufficient payment are prone towards corruption because they can collude with taxpayers to accept bribes to satisfy their needs. People may opt for corrupt activities when basic needs such as fees for children’s education, private medical services, and utility expenses are not covered by the basic salary provided by government. Lower and uncompetitive remuneration also will lead to the loss of competent and experienced IRD employees to private enterprises.

Inappropriate recruitment processes will ultimately lead to recruitment of the wrong people who will be unable to carry out their duties as tax officials. Incompetent people may be assigned to sensitive positions. People working temporarily cannot be devoted and well-disciplined like those in permanent employment who do their best for promotion and other material career benefits.

The absence of continuous in-house training programmes in the IRD is another reason that reduces employees’ capacities in dealing properly with taxpayers.

The absence of own transportation means within the IRD results in delays in some activities, which need quick rectification. People who administer vehicles may not understand the activities that need urgent transportation and therefore they may not allow the use of the vehicles at the right time. Inspection and tax assessment committees may for example not be able to move and to carry out their obligations when it is necessary.

The absence of sufficient vehicles, together with inadequate office space, telephone facilities and computers are also unwelcoming to taxpayers, demoralize the staff, and are not conducive to modern tax operations (Section 4.3.2.5). As a result, it is common to see people crowded in small offices that lack basic equipment and facilities at the end of the tax year. That leads to the

misplacing and losing of files and out-dated records as in the case of Jamaica before the reform of the tax administration (Section 3.2.2).

5.6. THE EFFECT OF TAX AMENDMENT ON TAX ADMINISTRATION

A discussion will follow on the effect of the amendment of Proclamation No.62/1994 and Proclamation No.64/1994 and their replacement by Proclamation No.116/2001 and Proclamation No.117/2001 respectively. These amendments were carried out in order to simplify tax administration because as has been stressed in Sections 2.7.2 and 3.2.1.1, a badly conceived or unnecessarily complicated tax structure greatly confuses the function of tax administration.

5.6.1. Employment tax

As shown in Tables 2 and 3, the new tax brackets are simpler and the maximum rate is 30 percent compared to the old rates of 38 percent. However, the new rates are detrimental to low-income earners. For instance if one takes two employees A and B with monthly gross incomes of ERN 500 and 8000 respectively, employee A is worse off by ERN 9 (25-34) while employee B now can save ERN 71 (2035-1964) each month as calculated from Tables 2 and 3 (see Annexure D). People with incomes higher than ERN 8000 can save 8(38-30) percent more of their income than they could before the amendment. But still the ability-to-pay principle is observed as has been described in Section 2.6.2. The logic behind lowering the rate for high-income earners and minimizing brackets is to encourage people not to avoid or evade taxation. This is true because if tax rates are high these people will look for loopholes to avoid or evade taxes and that will lower the revenue of the government significantly and compromise the achievement of the revenue goal of taxation (Section 2.7.6.1).

However, a simple bracket system and the formulae provided are helpful in the introduction of self-assessment as simplification of tax administration procedures because complexities of tax structures have a negative impact on tax administration (Section 2.7.2).

5.6.2. Rental tax

Tables 4 and 5 show that the new rates are low especially for people with a higher income to encourage them to invest their capital in the construction of houses for rent to address the problem of insufficiency of rental houses in Eritrea. These changes are beneficial to lessors and lessees as well. For the lessees the price will be affordable when a greater number of houses are built providing greater competitiveness in the rental market and at the same time the lessors' income after tax will be more attractive.

Before the amendment, tax rates for the high-income brackets were excessive and this increased the tendency of taxpayers towards tax evasion and avoidance as has been described in Section

2.7.6.1. The brackets previously were too numerous and made the tax system too complex and cumbersome for most people to calculate their taxes.

But, the difference in saving which has arisen as a result of the amendment is insignificant to people of lower rental income. For example, a lessor with annual income of ERN 1000 will save ERN 19.6 (39.6 -20) more each year as shown in Annexure E. But people with very lower incomes are worse off now. For example, a lessor with an income of ERN 120 pays ERN 1.4 (2.4-1.0) more than he/she used to pay before the amendment, as calculated from Tables 4 and 5. People with higher income will clearly benefit most. If the income is more than ERN 42,000 per year, the difference in saving will be 18(48-30) percent more than it was before 2001. That is a significant difference that encourages people to invest in the construction of houses for rent.

5.6.3. Tax from trade, business and professional activities

As reflected in Tables 6 and 7 unincorporated business enterprises are better off after the amendment. Enterprises with income of more than ERN 150000 can now save 18 (38-30) percent more than before the amendment. This is also true for companies with limited liabilities because the maximum tax rate has been reduced from 35 to 30 percent. The new tax structure also enables most people to know their share of taxes simply by using the published formulae.

As this sector is the major source of tax revenue in Eritrea, the reduction of tax rates provides further incentives to motivate business people to file tax returns and to pay their taxes without delay and this helps in achieving the revenue objective of taxation (Section 2.4.1). The lowering of tax rates also has another implication on the overall economy of Eritrea. It encourages people to invest their capital and initiate extra business activities that create jobs for citizens. This contributes to achieving the economic regulation objective of taxation (Section 2.4.3).

5.6.4. Agricultural tax

The amendments of 2001 have not affected tax rates in the agricultural sector. As shown in Tables 8 and 9, the taxes are especially low for traditional farming. The tax rates are not high if they are compared to the prices of animals at sales. For example an adult camel and sheep cost more than ERN 5000 and 500 respectively. However, the most common phenomenon in rural areas is that peasants are not aware that paying tax is their duty. Most of them do not know that taxes are used to pay for public services provided by the government to them as mentioned in Section 2.4. Some may try to conceal the right amount of their livestock as a way of avoiding or evading taxes.

5.6.5. Sales and excise taxes

As has been explained in section 4.4.5.1 and as depicted in Tables 10 and 11, there has been an increase in tax rates on cigarettes and tobacco products. The logic behind this increase in tax rates is to raise tax revenue to offset the tax rate reduction in income tax rates. It also has the objective of reducing consumption of these products and encouraging people to save more by increasing the price of nonessential commodities. Discouraging consumption of these products may move people away from incurable diseases. These are among the main objectives of consumption taxation as explained in Section 2.5.2. But this increase may lead to avoidance or evasion if proper measures of control are not in place. In addition, the large number of exemptions on goods and services may lead to tax evasion and avoidance to make tax administration more complex (2.7.6.1).

There is a sharp decrease in the rates applicable to automobiles to encourage people to purchase quality products such as Land Rovers, Land Cruisers, and Jeeps that are durable and could provide long service in Eritrea, whose highway infrastructure is under construction.

5.7. TAX COLLECTION ENFORCEMENT TOOLS

As has been clarified in Section 2.7.4.1, the existence of appropriate penalties facilitate a tax system's smooth functioning. But Section 4.5 suggests that the maximum penalty in Eritrea is 50 percent and there is no interest payable for late payment. The absence of interest charges can motivate people to invest that money in other business activities that yield higher rates of return and to pay their taxes late. Tax penalties are not indexed in order to match inflation. If there is no indexation during periods of inflation, the true value of money at the time of payment is less than the assessed amount of tax. This will be disadvantageous to the government. On the other hand, during deflation of prices, the true value of the amount of the tax at the time of payment is more than at the time at which it was assessed. In this case it will be harmful to taxpayers. The experience of Bolivia is a good example of how to avoid such problems (Section 3.2.1.1).

The absence of demand payment from bank accounts and non-issuance of liens for delinquent taxpayers mean that the tax authorities in Eritrea have no lever to control delinquent taxpayers. Issuance of liens effectively prevent delinquent taxpayers from selling properties that may later be subject to seizure. Such instruments help to redress blatant cases of non-payment and prevent unviable enterprises from continuing to accumulate tax arrears that have no possibility of being collected. So the non-existence of these most effective and commonly used collection enforcement tools may lead to non-compliance and more arrears.

Furthermore, the absence of clear eligibility conditions for paying debt in instalments could lead to the loss of government revenue as mentioned in Section 4.5. The experience of Bolivia as mentioned in Section 3.2.1.1 suggests the best ways of controlling instalment payments.

5.8. THE IMPLICATION OF OTHER CHANGES

As has been mentioned in Section 4.4.1, the absence of control mechanisms to check people who work in NGOs and embassies will lower government revenue and will encourage others to follow the same route to avoid taxes.

As has been stated in Section 4.4.6, the availability of duty stamps at a limited number of locations could create difficulties especially to the elderly and people in rural areas. For instance, a simple court or other administrative case could take a long time if it is necessary to submit any stamped forms.

Finally, the establishment of a LTO offers important benefits to tax administration. It has the potential to secure significant revenue increases in the near future by improving the efficiency of tax administration as has been argued in Section 2.7.4.2. An LTO can provide a vehicle for developing new tax administration procedures, which after being fully tested, can be extended to other categories of taxpayers and tax offices. Further, an LTO can help to improve Eritrea's investment environment by giving experience to tax officers who are trained in complex areas of tax laws that often arise in relation to large investors.

5.9. SUMMARY AND CONCLUSION

The analysis in this chapter suggests that there are shortcomings in mobilizing revenue by way of taxation in Eritrea.

The out-dated administrative procedures in most the IRD offices are a source of inconvenience to both the taxpayers and the tax officials. The absence of in-house publications and continuous taxpayer education are also other factors that contribute to the misperception most people harbour concerning the financial capability of the government and the objectives of taxation. Accountability of public officials to the public is also impossible without transparency.

In addition, corruption will prevail if employees are not given more generous remuneration and other additional monetary incentives.

The amendment of the tax structure is an effort to simplify tax administration, enhance investment and saving and reduce the consumption of hazardous commodities.

This chapter delineates the tax administration in Eritrea as needing comprehensive reform in order to achieve efficiency and effectiveness. The poor financial indicators and the outdated and

control-oriented procedures indicate the need for a close study and reform of tax administration in Eritrea. The introduction of compatible computer systems and human resource management need special focus.

The following chapter will provide conclusions to this study and present recommendations.

CHAPTER SIX

6. CONCLUSION AND RECOMMENDATIONS

6.1. CONCLUSION

Although Eritrea started to function as an independent nation only in 1991, it has tried to accomplish social, economic and other goals in order to improve the standard of living of a population impoverished for over a century by the inhuman policies of foreign colonial powers. Since 1991 many policies have been formulated to redress the pre-independence damage in all sectors. In fact, there have been some signs of successes in a number of fields. On the other hand, there are also shortcomings because the implementation of such policies requires significant resources and skills.

It is logical to expect that Eritrea should have public services that are underdeveloped at this time due to the limitation of resources. But this does not mean that Eritrea should wait with folded hands without evaluating performance of the public services and taking appropriate measures to improve them.

As discussed in this thesis, tax administration in Eritrea needs reforms in order to be effective and efficient. These reforms should be carried out gradually within a given framework. Eritrea can learn many lessons about tax administration reform from different countries that have rich experience in this field.

The following recommendations will help the IRD in achieving its objectives.

6.2. RECOMMENDATIONS

In order to become customer friendly, more efficient and effective, and less corrupt and to improve the organisation and management of tax administration it is important for the IRD to focus on the following issues.

Increasing the effort of modernisation

The IRD should consider opportunities for improving tax administration presented by new technologies and particularly the advances in telecommunications, because these advances allow citizens to fulfil their tax liabilities with greater ease. Such advances will allow the IRD to offer to the citizens the possibility of accessing its information system to query their data. In this manner, tax liable parties will be able more accurately to complete their returns and they will be able to know what tax debts are outstanding.

As discussed earlier, technology is the primary enabling resource for the IRD to be user-friendlier in delivering services on schedule in a way desired by taxpayers and at lower cost. The introduction of up-to-date technology will also improve the accuracy and speed of the processing of taxes and organisation of end-user requests for information and services. The need for face-to-face encounters will be replaced by telephones, personal computers in homes and offices and publicly available computers in designated places. This long-term vision for information technology in the IRD should be based on the primary need to develop an information management infrastructure that provides complete, accurate, and up-to date information, which is delivered in a useful manner and at a reasonable cost. This information infrastructure should consist of an integrated countrywide communication network and uniform technical features and characteristics, which will ensure that all taxpayers, agents and related organisations will be able to share information and integrate services within an environment that satisfies the appropriate levels of security.

Improving human resource conditions

The experience of many countries on tax administration shows that that the most important pre-requisite for any effective tax administration is the availability of well-qualified, highly-trained and well-motivated personnel. Without the right quality of personnel, no tax administration in the world can ever hope to succeed. So to attract and to retain highly qualified professionals such as accountants, lawyers, valuers, computer specialists and the like, the IRD should offer special incentives. The incentives could include:

- The basic salaries of the employees in this department should be higher than those of other civil servants. That is people should be paid on a similar scale as their counterparts in the private sector;
- Professionals should be offered special incentives such as rent-free and furnished accommodation, the free use of car and other entertainment allowances;
- Staff members should be entitled to a certain percentage of their basic salaries as leave allowances, modest clothing allowance, canteen and transport allowances;
- There should be a certain percentage of basic salary as bonus in any year in which the service exceeds its targets; and
- Finally, there should be the opportunity for promotion and career path development.

Privatisation of certain areas in tax administration

As a long-term plan, tax administration policy-makers should start thinking about the possibility of privatisation of certain activities, which could be better performed by the private sector. The private sector may carry out activities such as computer services; issuing and sending of tax forms and reports on paid taxes; gathering, sending and filling in documents; and correspondence with taxpayers. For example, banks and post offices should be used to provide basic task administration such as providing forms, accepting payment and returns from taxpayers in small cities combined with mobile tax offices to periodically carry out audit and enforcement, as means of privatisation. This could resolve the shortage of resources in tax administration because banks and post offices are already specialized in the handling and control of payment. However, the IRD must exercise adequate supervision and the remuneration paid to the banks and other enterprises must be appropriate. There must be direct link-ups between banks and tax administration offices in order to reduce time wastage for taxpayers. This will also minimise taxpayer-tax collector interaction to avoid corruption and other forms of fraudulent actions. But there should not be excessive privatisation, which could work at the expense of citizens.

Taxpayer education

Taxpayer education is a fundamental issue that motivates people to comply voluntarily with their tax obligations. This enables people to know why taxes are collected and how taxes are used to improve their living conditions.

As a means of inducing taxpayer compliance, the IRD organisational chart should include divisions concerned with taxpayer education and public relations. These divisions should prepare tax education programmes, publish and distribute pamphlets on tax matters and members of this division should go around towns and villages to advise and educate taxpayers on how to honour their obligations. These booklets, newsletters and pamphlets could be provided free of charge or with nominal fees. In addition, there should be a continuous tax column reserved in the public newspapers. It would also be helpful if top tax officials could travel throughout the country to give presentations and seminars to various communities and the public at large to explain the objectives of tax systems because taxpayers who are aware of their rights and expect, and in fact receive, fair and efficient treatment are generally more willing to comply.

There must also be transparency in reflecting the projected and actual tax collected. In order to follow up on the implementation of these programmes, informed and better procedures should be introduced. When people are better informed on the implementation of government projects and their control their preparedness to bear a tax burden improves. Government programmes should be publicized and be more transparent in order to enhance the people's participation and control.

Customer service centres should be equipped with toll free numbers, information desks and detailed customer education pamphlets. These centres should be “one-stop-shops”.

There should be regular radio and television programmes in collaboration with entertainment providers to enhance the knowledge of people about taxation.

Finally, the introduction of courses related to taxation in the educational system in Eritrea would be of great help in educating people to know their obligations and to assess their taxes.

Training programmes

Specialized training programmes should be introduced for tax officers in the field of auditing, tax law and accounting procedures. This will help officers to seek relevant information and detect tax evasion when they visit business premises. At a minimum, training programmes must be developed in the area of audit, collection, enforcement and taxpayer service. In the budget of the IRD there should be a provision for the training of staff, both locally and abroad. Such training should sufficiently equip the IRD employees to enable them keep abreast with best practice developments internally.

Enforcement measures

The following enforcement measures are recommendable to prevent delinquency in tax administration:

- Tax authorities should demand bank accounts of delinquent taxpayers;
- Tax officials should issue a lien on the physical property from delinquent taxpayers;
- Delinquent taxpayers should be disqualified from bidding on government contracts;
- Delinquent taxpayers should be denied certain government services; and
- The names of delinquent taxpayers must be published in newspapers or other public publications.

In addition, the IRD would be in a better position if the following recommendations were implemented:

- Exceptions and deductions for families of lower income, so the taxation system is fair to the low-income earners as well;
- The interest charged for failure to pay the balances due must be related to the cost of borrowing money commercially and the rate should be above the normal bank rates. In addition, the 50 percent cap on interest should be removed and this interest should keep accruing, as long the debt remains unpaid;

- There must be performance measures such as revenue collection targets by year or month, percentages of tax returns processed within given days of receipt, percentages of outstanding declarations at the end of each month, percentages of arrears to total collection and the number and types of audits to be conducted;
- The valuation of homogenous items should be done by estimation from the respective benchmarked properties;
- Tax declaration forms should be designed in a way to provide room for tax return and payment at the same time;
- There must be coordination between different ministries to stop delinquent taxpayers. E.g. in urban areas the Ministry of Education should request from students a proof of tax paid during registration or the Ministry of Health may ask people to present tax clearance proofs during admission on non-emergency cases to check whether people are paying taxes or not;
- There must be a special means of controlling taxes from rent;
- The IRD should keep predetermined percentages of the tax collected to invest in motivating its employees;
- The IRD should have its own means of transportation for at least emergency tax purposes;
- Special measures must be introduced to ensure that withholding agents report properly to the tax receiver at the right time;
- A permanent watchdog body must be created comprising representatives from the tax administration, taxpayers and professionals. This body must oversee the implementation of all corruption reduction initiatives in the tax administration on an ongoing basis. It should publish an annual report on the state of integrity of the IRD;
- The introduction of self-assessment for taxpayers in Category B will free tax officers to concentrate on enhancing compliance by pursuing taxpayers who fail to file returns, conducting audits and through taxpayer education;
- The introduction of VAT instead of sales tax in order to make use of the administrative advantages VAT system provides in relation to sales taxes; and
- Further and detailed studies on tax administration must be conducted.

Finally for Eritrea to develop a well-advanced tax administration, political commitment from the people at the top and international support in terms of expertise and finance are essential for successful reform. The participation of taxpayers in policy-making is also another important factor for any policy related to taxes to succeed and in order to ease its implementation and encourage compliance.

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ANNEXURES

Annexure A

| ERN' 000000 | Eritrean government Revenues (1997-2001) | | | | |
|----------------------------------|--|--------------|---------------|---------------|---------------|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| Total Revenue | 2042.8 | 1898.9 | 2149.7 | 2020.1 | 2182.5 |
| Tax Revenue | 959.4 | 976.9 | 1018.6 | 1032.4 | 1407.5 |
| Direct taxes | 447.9 | 512.3 | 518.6 | 553.2 | 595.2 |
| Personal taxes | 117.2 | 128 | 131.4 | 197.5 | 219.6 |
| Business profits | 292.9 | 334.1 | 337.7 | 299.6 | 315.1 |
| Rehabilitation tax | 18.1 | 17.5 | 11.3 | 12.8 | 15.9 |
| Other | 19.7 | 32.7 | 38.2 | 43.3 | 44.6 |
| Domestic indirect taxes | 212.8 | 198.5 | 236.8 | 215.6 | 427.9 |
| Import duties and taxes | 298.7 | 266.1 | 263.2 | 263.6 | 384.4 |
| Custom duties | 184.2 | 167.3 | 162 | 159.8 | 195.6 |
| Sales and other taxes on imports | 114.5 | 98.8 | 101.2 | 103.8 | 188.8 |
| Non tax revenue | 1063.4 | 597.8 | 600.1 | 490.9 | 526.6 |
| Port fees and charges | 444.3 | 99.7 | 107 | 11.7 | 0 |
| Other fees and charges | 93.3 | 86.7 | 102.6 | 76.6 | 85.8 |
| Sales of goods and services | 25.1 | 52.8 | 40.8 | 40.7 | 45.5 |
| Sales of government property | 55.4 | 11.3 | 64.9 | 126.7 | 126.7 |
| Residual surplus and dividends | 327.7 | 151.2 | 157.7 | 125 | 158.5 |
| Others | 117.6 | 196.1 | 127.1 | 110.2 | 110.1 |
| Extraordinary revenue | 20 | 324.2 | 531 | 496.8 | 248.4 |
| Public contribution | 0 | 148.3 | 131.4 | 248.9 | 124.7 |
| Surtax | 0 | 26.8 | 276.9 | 247.9 | 123.7 |
| Capital revenue | 20 | 149.1 | 122.7 | 0 | 0 |
| | In percent of GDP | | | | |
| Total revenue | 43.3 | 37.8 | 39.2 | 34.4 | 29.8 |
| Tax revenue | 20.4 | 19.4 | 18.6 | 17.6 | 19.2 |
| Direct taxes | 9.5 | 10.2 | 9.5 | 9.4 | 8.1 |
| Personal income | 2.5 | 2.5 | 2.4 | 3.4 | 3 |
| Business profits | 6.2 | 6.6 | 6.2 | 5.1 | 4.3 |
| Rehabilitation tax | 0.4 | 0.3 | 0.2 | 0.2 | 0.2 |
| Other | 0.4 | 0.7 | 0.7 | 0.7 | 0.6 |

Source: Ministry of Finance

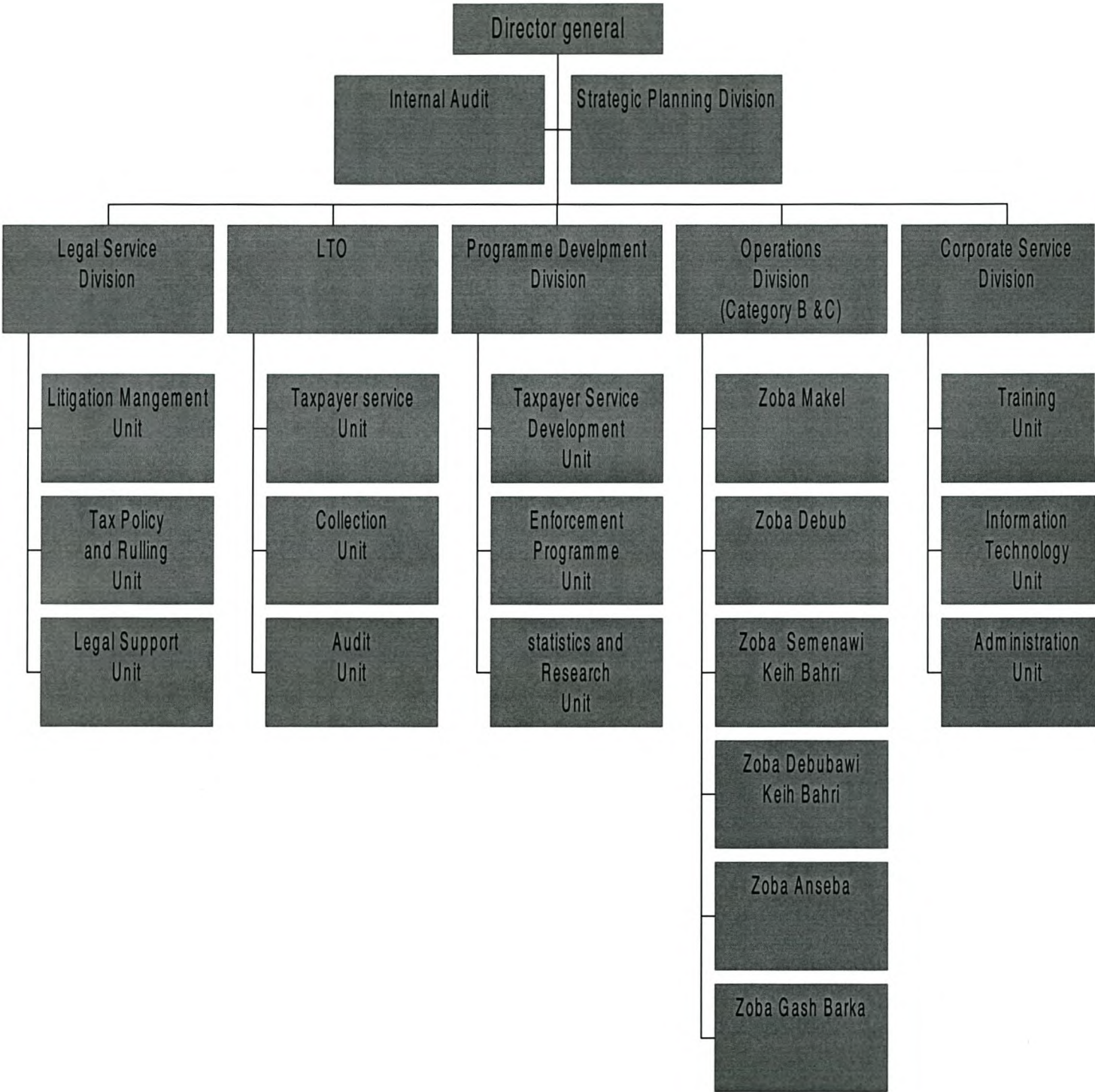
Annexure B

| ERN'000000 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|------------------------------------|---------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Total revenue and grants | 670.2 | 1400 | 1688 | 1837 | 1738 | 2354 | 2510 | 2584 | 3252 | 3349 |
| Revenue | 488.8 | 893.2 | 1062 | 1346 | 1395 | 2064 | 2051 | 2226 | 2292 | 2019 |
| Tax | 297.6 | 517.6 | 657.5 | 716.2 | 830.5 | 959.4 | 1004 | 1296 | 1237 | 1429 |
| Nontax | 191.2 | 375.6 | 369 | 629.6 | 559.4 | 1084 | 896.6 | 833 | 1029 | 519.9 |
| Privatization Revenue | 0 | 0 | 35.6 | 0 | 5 | 20.4 | 150.4 | 97.3 | 25.9 | 70.9 |
| Grants | 181.4 | 507 | 626 | 491.1 | 342.7 | 290.5 | 458.4 | 358 | 959.8 | 1330 |
| | | | | | | | | | | |
| Total expenditure | 735 | 1571 | 2005 | 2680 | 2722 | 2589 | 3832 | 5012 | 5940 | 6442 |
| Current expenditure | 643.4 | 1104 | 1575 | 2131 | 1883 | 1446 | 2395 | 2746 | 4262 | 4168 |
| Capital expenditure | 91.6 | 466.8 | 430.3 | 548.8 | 839.1 | 1144 | 1437 | 2266 | 1678 | 2274 |
| Overall balance | -64.8 | -170 | -317 | -843 | -985 | -235 | -1323 | -2428 | -2689 | -3093 |
| | | | | | | | | | | |
| Financing of the Deficit: | 64.8 | 170.3 | 316.7 | 843.2 | 984.7 | 234.9 | 1323 | 2428 | 2669 | 3093 |
| External Loans | 0 | 12.6 | 118.6 | 46 | 55.7 | 184.4 | 435.3 | 836 | 2187 | 2015 |
| Domestic Borrowing | 64.8 | 157.7 | 130.8 | 763.9 | 899.1 | 48 | 887 | 1592 | 482 | 1078 |
| Counterpart funds from ext. grants | 0 | 0 | 67.3 | 33.3 | 29.9 | 2.5 | 0.2 | 0.5 | 0 | 0 |
| | (In percent of GDP) | | | | | | | | | |
| Total revenue and grants | 30.59 | 49.21 | 45.61 | 44.83 | 37.14 | 45.39 | 43.26 | 41.9 | 52.34 | 44.46 |
| Revenue | 22.31 | 31.39 | 28.7 | 32.85 | 29.82 | 39.79 | 35.36 | 36.1 | 36.89 | 26.81 |
| Tax | 13.58 | 18.19 | 17.76 | 17.48 | 17.75 | 18.5 | 17.31 | 21 | 19.91 | 18.96 |
| Nontax | 8.727 | 13.2 | 9.97 | 15.37 | 11.96 | 20.9 | 15.46 | 13.5 | 16.56 | 6.902 |
| Grants | 8.28 | 17.82 | 16.91 | 11.99 | 7.326 | 5.602 | 7.902 | 5.81 | 15.45 | 17.65 |
| | | | | | | | | | | |
| Total expenditure | 33.55 | 55.19 | 54.17 | 65.41 | 58.19 | 49.92 | 66.06 | 81.3 | 95.62 | 85.52 |
| Current expenditure | 29.37 | 38.79 | 42.54 | 52.02 | 40.26 | 27.87 | 41.28 | 44.5 | 68.6 | 55.33 |
| Capital expenditure | 4.181 | 16.41 | 11.63 | 13.39 | 17.94 | 22.05 | 24.78 | 36.7 | 27.02 | 30.19 |
| Overall balance | -2.958 | -5.99 | -8.56 | -20.6 | -21 | -4.53 | -22.8 | -39.4 | -43.3 | -41.1 |
| | | | | | | | | | | |
| Financing of the Deficit: | 2.958 | 5.985 | 8.557 | 20.58 | 21.05 | 4.53 | 22.8 | 39.4 | 42.96 | 41.06 |
| External Loans | 0 | 0.443 | 3.204 | 1.123 | 1.191 | 3.556 | 7.504 | 13.6 | 35.2 | 26.75 |
| Domestic Borrowing | 2.958 | 5.542 | 3.534 | 18.64 | 19.22 | 0.926 | 15.29 | 25.8 | 7.758 | 14.31 |
| Counterpart funds from ext. grants | 0 | 0 | 1.818 | 0.813 | 0.639 | 0.048 | 0.003 | 0.01 | 0 | 0 |

Source: Ministry Of Finance

Annexure C

Organizational Chart of IRD



Annexure D

| Salary | Table 2 | Table 3 |
|-----------------------|--|---------------------------------|
| ERN 500 (employee A) | $200 \times .02 = 4$ $300 \times .07 = \underline{21}$ 25 | $(500 \times .01) - 16 = 34$ |
| ERN 8000 (employee B) | $200 \times .02 = 4$ $300 \times .07 = 21$ $700 \times .12 = 84$ $800 \times .17 = 136$ $1500 \times .24 = 360$ $2000 \times .29 = 580$ $2500 \times .34 = \underline{850}$ <u>2035</u> | $(8000 \times .3) - 436 = 1964$ |

Annexure E

| Rent | Table 4 | Table 5 |
|----------|---|--------------------------|
| ERN 1000 | $120 = 1.0$ $260 \times .015 = 3.9$ $100 \times .03 = 3.0$ $180 \times .045 = 8.1$ $180 \times .06 = 10.8$ $160 \times .08 = \underline{12.8}$ 39.6 | $(1000 \times .02) = 20$ |

Annexure F**Questionnaire**

Dear Sir/ Madam,

I am a student of public administration in the School of Public Management and Planning in Stellenbosch-South Africa. As part of the requirement for the masters degree, I have started to write my dissertation about a topic related to tax administration of Eritrea by Inland Revenue Department (IRD). I was motivated to study about this topic because it was one of the researchable areas that were proposed and sent to the Eritrean students in South Africa by Mr.Berhane Abrehe, the minister of Finance last year.

So, I would like to solicit your kind assistance by answering the following questions.

The answers you will be giving are purely to serve an academic purpose.

Thank you in advance for your help and cooperation.

Yours Sincerely,

Ogbagergis Hailemichael Arey

South Africa

INSTRUCTIONS

Please insert ticks in the given boxes. You may put more than one tick in a question.

1.What was the amount of tax collected in the last six years in relation to GDP? Please insert the figures in the following table.

| Years | 1997 | 1998 | 1999 | 2000 | 2001 |
|------------------------------|------|------|------|------|------|
| Total Tax collected | | | | | |
| Gross Domestic Product (GDP) | | | | | |

2. Which kinds of taxes are collected by Internal Revenue Department (IRD)? Please put ticks in the given boxes. Personal income tax ☐ sales tax ☐ lease taxes ☐ company

turnover ☐ Property tax ☐ Agricultural taxes ☐ Others ☐ (mention them)

3. Does the IRD keep a certain percentage of tax collected for any investment for specializing or educating its employees or for purchasing facilities?

Yes ☐ No ☐

4. Are all the staff members of IRD fully aware of the mission and objectives of this organisation?

Yes ☐ No ☐

5. If the answer in No. 6 is yes, how is it done?

Workshops ☐ Seminars ☐ Orientation ☐ Part of on-the-job-training ☐ Others (mention them) ☐

6. How is the public become aware of the mission, strategies and functions of IRD? Through

Workshops ☐ Seminars ☐ Media ☐ Special newsletters published by IRD
Others (mention them) ☐

7. Is there any initiative taken by Commercial Bank of Eritrea to accept payment instead of IRD at this time? So, that the taxpayers need not have to go to IRD offices.

Yes ☐ No ☐

8. How many types of tax declaration forms are there in Eritrea? They are:

Sales ☐ Profit ☐ Personal income ☐

9. These tax-declaration forms are self-guiding, so that the taxpayers can complete (fill) them easily.

Completely agree ☐ Agree ☐ Completely disagree ☐

10. How many pages are there in each type of tax-declaration form?

One ☐ Two ☐ Three ☐ Four ☐ More than four ☐

11. Does the tax form allow recording both the tax return and payment at the same time?

Yes ☐ No ☐

12.How is valuation of homogenous items carried out?

Estimation from the respective benchmarked properties ☐ Physical inspection of all items ☐

13.Can a taxpayer with different types of taxes pay them in one office? For example, can income and sales taxes be paid in one office at the same time by a taxpayer?

Yes ☐ No ☐

14.Can taxpayers settle their taxes in instalments?

Yes ☐ No ☐

15.Are there regular television or radio programmes concerning taxation at this time in Eritrea?

Yes ☐ No ☐

16. Is there any interest charged for late taxpayers?

Yes ☐ No ☐

17. If the answer in no.16 is yes, what is the interest rate?

18.Is this interest rate more than that of the bank interest rate?

Yes ☐ No ☐

19.Are the salaries of IRD employees in all categories of taxes the same?

Yes ☐ No ☐

20. How are the salaries of IRD employees compared to those of private sector enterprise given that they have the same qualification and experiences?

Same ☐ lower ☐ Higher ☐

21.What incentives are there to motivate IRD employees not to be involved in corruption? Are there any rewards for high achievements?

Cash bonuses ☐ Certificate of merit ☐ Promotion ☐ Salary rise ☐ Leave allowances ☐ Transport allowances ☐ Canteen allowances ☐ None ☐

22.How is controlling of taxpayers carried out?

Checking every taxpayer at regular interval ☐ Checking taxpayers selectively at irregular intervals ☐

23.How do people forward their complaints about taxes? Through help desks ☐ Suggestion box ☐ Seminars & meeting ☐ Direct dialogue with IRD administration ☐ Through public media ☐

24. Are the complaining procedures widely known to the public and easy to understand?

Yes ☐ No ☐

25.The percentage of total tax revenue of largest taxpayers' share account for

Less than 50% ☐ more than 50% ☐

26.Is there any initiative to include courses about taxation in Eritrean educational curriculum?

Yes ☐ No ☐